INSIDE THIS WEEK: A 10-PAGE SPECIAL REPORT ON TEXAS

The Economist

JULY 11TH–17TH 2009

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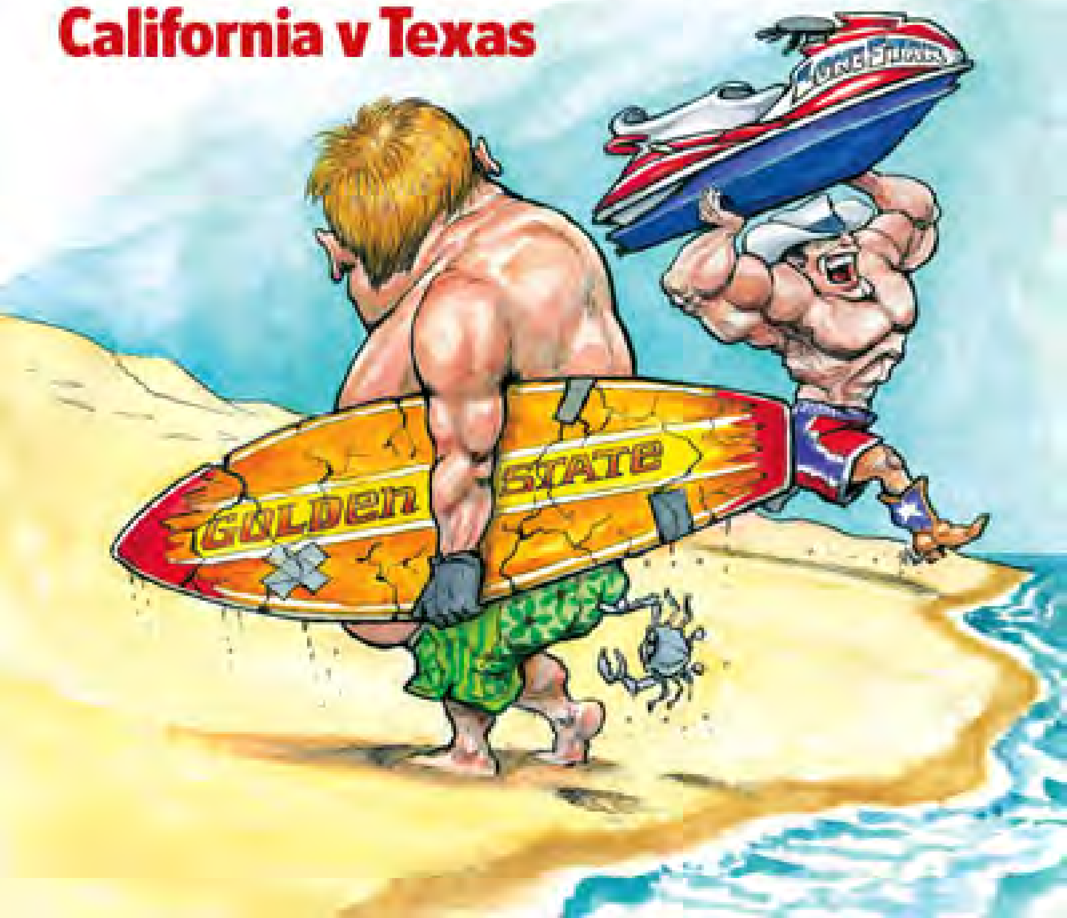
# America's future

## California v Texas



TEXAS: AMERICA'S FUTURE? A SPECIAL REPORT

# The Economist

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The public-sector pension scam

The surge in Afghanistan

Hollywood in recession

Eat less, live longer: it's true

Don't protect bad Belgian art

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## The dark side of China's growth

# Print edition July 11th 2009

**America's future**

An intriguing, much more equal rivalry out West. But both California and Texas can learn from each other: leader

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# Politics this week

Jul 9th 2009
From The Economist print edition

China deployed thousands of troops to regain control of Urumqi, the capital of the western region of **Xinjiang**, after three days of rioting between Muslim Uighurs and Han Chinese. At least 156 people were killed and more than 900 injured in the violence, the worst outbreak of civil disorder in China since the suppression of the Tiananmen demonstration in 1989. The government said most of the dead were Han Chinese; the Uighurs claimed most of the victims as their own. See article

Reuters

A gaunt **Kim Jong Il** made a rare public appearance on the 15th anniversary of the death of Kim Il Sung, his father. The North Korean dictator is said to be preparing his youngest son to succeed him. Meanwhile, North Korea was accused of being behind a cyber-attack that shut the websites of government departments in the United States and South Korea.

American troops continued their efforts to retake Taliban strongholds in **Afghanistan's** Helmand province, assisted by British troops in a parallel operation. Coalition casualties increased sharply. A truck bomb in Logar province killed at least 24 people. See article

Susilo Bambang Yudhoyono, **Indonesia's** incumbent president, convincingly won re-election, according to unofficial "quick-count" projections. He seemed likely to win about 60% of the total popular vote and to clear the other threshold needed for victory: acquiring at least 20% of the vote in 17 or more of Indonesia's 33 provinces. See article

**India's** budget lavished money on farmers, middle-class taxpayers and infrastructure, but disappointed the markets by not liberalising foreign investment or labour laws. The Congress-party-led government forecast that the economy would grow by 9% next year. See article

## A political revival

In a setback for President Felipe Calderón, **Mexico's** formerly ruling Institutional Revolutionary Party (PRI) did well in mid-term elections, coming close to winning a majority (with allies) in the lower house of Congress. The PRI also won five of six state governorships at stake. See article

Manuel Zelaya, president of **Honduras**, who was ousted by a military coup last month, made an abortive attempt to fly back to his country. The army blocked the airport runway; one demonstrator was killed. Honduras was suspended from the Organisation of American States (OAS) over the coup. Both Mr Zelaya and Roberto Micheletti, the de facto president, agreed to meet Óscar Arias, Costa Rica's president, who is trying to mediate. See article

In **Venezuela** Antonio Ledezma, an opposition politician who was elected as mayor of Caracas, staged a hunger strike in the local office of the OAS in protest at the decision by President Hugo Chávez to transfer his budget and powers to an appointed official from the ruling party.

## Striving to achieve

AFP

Barack Obama visited Moscow for the first formal **America-Russia summit** of his presidency. The two countries agreed to resume nuclear-disarmament talks. But though the Americans had talked of pressing a "reset" button, the atmosphere on both sides was pragmatic and reserved rather than friendly. See article

Leaders of the G8 club of rich countries met for the annual **G8 summit** in

L'Aquila, Italy, presided over by Silvio Berlusconi. Brazil, China, India, Mexico, South Africa and Egypt joined the G8 for talks on climate change, though China's president cancelled his planned visit so he could tackle the crisis in Xinjiang. See article

**Bulgaria's** election was decisively won by the centre-right opposition. Boyko Borisov, now mayor of Sofia, will replace the Socialist leader, Sergei Stanishev, as prime minister. See article

The new prime minister of **Croatia**, in succession to Ivo Sanader, is to be Jadranka Kosor, his deputy. The causes of Mr Sanader's unexpected resignation remain a mystery. See article

A tabloid newspaper owned by Rupert Murdoch in **Britain** came under fire when it emerged it had allegedly employed private investigators to hack into thousands of mobile phones, including those of leading politicians.

## Fault lines

**California's** debt rating was downgraded to BBB, two notches above junk status, by Fitch, a credit-rating agency. As the state began issuing IOUs, a contentious special session was held in the state legislature to thrash out spending cuts. See article

In an announcement that took pundits by surprise, **Sarah Palin** said she would step down as Alaska's governor, 18 months before the end of her first term. Mrs Palin was John McCain's running mate in last year's election. A popular figure with the Republican grassroots and mentioned as a possible presidential candidate in 2012, she has become ensnared in a series of ethics scandals that have dimmed her star appeal. See article

Now with 60 votes in the **Senate**, Harry Reid, the Democratic majority leader, urged his party to unite against any Republican attempt to launch a filibuster. The Republicans think they may be able to persuade one or two moderate Democrats to join them in opposing some legislation.

**Robert McNamara** died at the age of 93. A former president of the Ford Motor Company and head of the World Bank, he became mired in the Vietnam debacle during his time as America's defence secretary from 1961 to 1968. See article

## Prisoner count

**Iran's** police chief said that more than 1,000 people had been arrested in the capital, Tehran, during unrest after last month's disputed presidential election, but that two-thirds had already been freed. Human-rights campaigners said that 2,000 people were still behind bars across Iran. The aggrieved presidential challenger, Mir Hosein Mousavi, continued to refuse to accept the official result, which gave victory to the incumbent, Mahmoud Ahmadinejad. See article

A week after American forces formally handed security in **Iraq's** towns to the Iraqi authorities, insurgents killed dozens of people in a rash of bombs in Baghdad, Mosul and other northern towns.

AFP

Some 70,000 **South African** building workers went on strike, demanding a pay rise of 13% and halting work at a number of stadiums where the football World Cup is due to be played next year. It is the biggest challenge to Jacob Zuma since he took office as president in May.

Economist.com OPINION

# Business this week

Jul 9th 2009
From The Economist print edition

Alistair Darling, Britain's chancellor, outlined proposals that would force **banks** to increase their capital to guard against future crises and give more enforcement powers to the Financial Services Authority, the City regulator. Banks that would pose a significant risk to the financial system if they collapsed would be subject to stringent capital and liquidity standards. His plans were criticised by the opposition Conservative Party, which said that, if elected, it would beef up the Bank of England's role instead. See article

Mr Darling's announcement came shortly after a meeting of European finance ministers, at which **Germany** asked for a temporary relaxation of Basel 2 rules on capital requirements in order to stimulate lending. Its request was denied.

**Sweden's** central bank unexpectedly cut its main interest rate in half, to 0.25%, on July 2nd. The Riksbank also reduced its deposit rate to -0.25% to encourage lending, a highly unusual move which means that banks will, in effect, pay the central bank 0.25% on overnight deposits.

France's **Société Générale** forecast that a €1.3 billion ($1.8 billion) loss from credit-default swaps will severely curtail its profit for the second quarter.

## The key is in the ignition

A judge approved the transfer of **General Motors'** profitable assets to a new government-run entity, clearing the way for the carmaker's speedy exit from bankruptcy protection. It declared itself insolvent on June 1st. The American government will hold a 61% stake in the new GM, which it hopes to shed next year after a restructuring programme.

**Car sales** surged by 48% last month in China compared with a year ago. Its auto market has been spurred since the government reduced by half the sales tax on small vehicles.

The head of **Rio Tinto's** iron-ore operations in China was detained on suspicion of stealing state secrets. Three other employees of the mining group were also held. China fell out with Rio after it rejected a big investment by China's state-backed aluminium firm. China is also trying to whittle down iron-ore prices in talks with Rio and other suppliers.

Gary Gensler, the head of America's Commodity Futures Trading Commission, said he would conduct hearings this summer on imposing limits on trading positions "for all **commodities** of finite supply" and whether to regulate the over-the-counter derivatives market. Some politicians in America and Europe insist that speculators are driving up the price of some commodities, particularly oil, and warn it could hamper economic recovery.

## Google Earth

**Google** announced, in a blog post, that it would launch an operating system for personal computers, thus opening a direct assault on Microsoft, which has dominated the market for years. The software will be unveiled later this year and will address many of the frustrations voiced by users of Microsoft Windows, such as slow computer start-up times. It will be aimed first at netbooks (small laptops), but will eventually be able to power fully fledged PCs. Analysts speculated that Google was trying to muddy the prospects for Microsoft's new Windows 7 operating system. See article

Boeing agreed to take over a factory in South Carolina that makes part of the fuselage for the troubled **787Dreamliner** project. It is the second time that Boeing has acquired a key supplier for its much-delayed new jet.

The European Union's competition regulator imposed its first penalty in the energy industry. **E.ON** and **GDF Suez** were each fined €553m ($769m) for their accord in 1975 not to compete over gas supplied through a pipeline in southern Germany.

The IMF issued a slightly better forecast for the **world economy** than the one it produced in April. It now expects output to grow by 0.8% in the United States next year, by 1.7% in Japan and by 8.5% in China. The EU will contract by 0.1%. The fund said that "financial conditions have improved more than expected, owing mainly to public intervention", but that stabilisation is "uneven" and recovery will be "sluggish".

## Move over Zurich

A report by Scorpio Partnership, which provides research on the **wealth-management** sector, found that private banks had $14.5 trillion in assets under management last year, down 16.7% from 2007. Bank of America, through its acquisition of Merrill Lynch, is now the world's largest asset manager, with most of its core assets in the United States.

**Assets under management**

End 2008, selected banks, $trn

| | |
|---|---|
| Bank of America | 1.50 |
| UBS | 1.39 |
| Citigroup | 1.32 |
| Credit Suisse | 0.61 |
| Morgan Stanley | 0.52 |
| HSBC | 0.35 |
| Goldman Sachs | 0.22 |

Source: Scorpio Partnership

The American Bankers Association said its measure of **delinquent loans** (where a payment is at least 30 days late) had reached a new record in the first quarter. Consumers made late payments on 4.75% of all bank-card accounts.

# KAL's cartoon

Jul 9th 2009
From The Economist print edition

Illustration by KAL

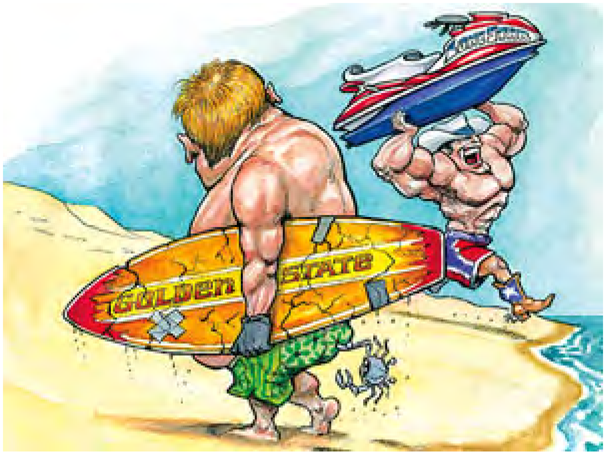
California v Texas

# America's future

Jul 9th 2009
From The Economist print edition

**An intriguing, much more equal rivalry out West. But both California and Texas can learn from each other**

Illustration by KAL




AMERICA'S recent history has been a relentless tilt to the West—of people, ideas, commerce and even political power. California and Texas, the nation's two biggest states, are the twin poles of the West, but very different ones. For most of the 20th century the home of Silicon Valley and Hollywood has been the brainier, sexier, trendier of the two: its suburbs and freeways, its fads and foibles, its marvellous miscegenation have spread around the world. Texas, once a part of the Confederacy, has trailed behind: its cliché has been a conservative Christian in cowboy boots, much like a certain recent president. But twins can change places. Is that happening now?

It is easy to find evidence that California is in a funk (see article). At the start of this month the once golden state started paying creditors, including those owed tax refunds, business suppliers and students expecting grants, in IOUs. California's governor, Arnold Schwarzenegger, also said that the gap between projected outgoings and income for the current fiscal year has leapt to a horrible $26 billion. With no sign of a new budget to close this chasm, one credit agency has already downgraded California's debt. As budgets are cut, universities will let in fewer students, prisoners will be released early and schemes to protect the vulnerable will be rolled back.

## They paved paradise and put up the parking taxes

Plenty of American states have budget crises; but California's illustrate two more structural worries about the state. Back in its golden age in the 1950s and 1960s, it offered middle-class people, not just techy high-fliers, a shot at the American dream—complete with superb schools and universities, and an enviable physical infrastructure. These days California's unemployment rate is running at 11.5%, two points ahead of the national average. In such Californian cities as Fresno, Merced and El Centro, jobless rates are higher than in Detroit. Its roads and schools are crumbling. Every year, over 100,000 more Americans leave the state than enter it.

The second worry has to do with dysfunctional government. No state has quite so many overlapping systems of accountability or such a gerrymandered legislature. Ballot initiatives, the crack cocaine of democracy, have left only around a quarter of its budget within the power of its representative politicians. (One reason budget cuts are inevitable is that voters rejected tax increases in a package of

ballot measures in May.) Not that Californian government comes cheap: it has the second-highest top level of state income tax in America (after Hawaii, of all places). Indeed, high taxes, coupled with intrusive regulation of business and greenery taken to silly extremes, have gradually strangled what was once America's most dynamic state economy. *Chief Executive* magazine, to take just one example, has ranked California the very worst state to do business in for each of the past four years.

By contrast, Texas was the best state in that poll. It has coped well with the recession, with an unemployment rate two points below the national average and one of the lowest rates of housing repossession. In part this is because Texan banks, hard hit in the last property bust, did not overexpand this time. But as our special report this week explains, Texas also clearly offers a different model, based on small government. It has no state capital-gains or income tax, and a business-friendly and immigrant-tolerant attitude. It is home to more *Fortune* 500 companies than any other state—64 compared with California's 51 and New York's 56. And as happens to fashionable places, some erstwhile weaknesses now seem strengths (flat, ugly countryside makes it easier for Dallas-Fort Worth to expand than mountain-and-sea-locked LA), while old conservative stereotypes are being questioned: two leading contenders to be Houston's next mayor are a black man and a white lesbian. Texas also gets on better with Mexico than California does.

American conservatives have seized on this reversal of fortune: Arthur Laffer, a Reaganite economist, hails the Texan model over the Gipper's now hopelessly leftish home. Despite all this, it still seems too early to cede America's future to the Lone Star state. To begin with, that lean Texan model has its own problems. It has not invested enough in education, and many experts rightly worry about a "lost generation" of mostly Hispanic Texans with insufficient skills for the demands of the knowledge economy. Now immigration is likely to reconvert Texas from Republican red to Democratic blue; Latinos may justly demand a bigger, more "Californian" state to educate them and provide them with decent health care. But Texas could then end up with the same over-empowered public-sector unions who have helped wreck government in California.

Second, it has never paid to bet against a state with as many inventive people as California. Even if Hollywood is in the dumps (see article), it still boasts an unequalled array of sunrise industries and the most agile venture-capital industry on the planet; there is no prospect of the likes of Google decamping from Mountain View for Austin, though many start-ups have. The state also has an awesome ability to reinvent itself—as it did when its defence industry collapsed at the end of the cold war. Perhaps the rejection of tax increases will "starve the beast" and promote structural reform. A referendum on a new primaries system could end its polarised politics. Mr Schwarzenegger's lazy governorship could come to be seen not as the great missed opportunity, but as the spur for reform.

## Fifty laboratories, one magic formula

The truth is that both states could learn from each other. Texas still lacks California's great universities and lags in terms of culture. California could adopt not just Texas's leaner state, but also its more bipartisan approach to politics and its more welcoming attitude towards Mexico. There is no perfect model of government: it is America's genius to have 50 public-policy laboratories competing to find out what works best—just as it is the relentless competition of clever new firms from Portland to Pittsburgh that will pull the country out of its current gloom. But, to give Texas some credit and serve as a warning to Mr Schwarzenegger's heir, at this moment America's two most futuristic states look a lot more like equals than ever before.

Economist.com OPINION LEADERS

Riots in Xinjiang

# Beijing's nightmare

Jul 9th 2009
From The Economist print edition

**The Uighurs' revolt undermines China's idea that its people will always happily trade freedom for prosperity**

SPOT the odd one out: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan, Xinjiang. Since the unravelling of the Soviet Union and the birth of the Central Asian republics, the vast swathe of China known as the Xinjiang Autonomous Region has seemed a cartographic anomaly. "Uighurstan" has never been on the cards for the ethnic-Turkic Muslims of the region, who now make up slightly under half its 20m population. But Communist Party officials in Beijing have nevertheless fretted about the linked threats of extremist Islam and secession. Vicious race riots this week in Xinjiang's capital, Urumqi, have caused the deaths of over 150 people and shown just what a hash the regime has made of fostering stability.

The bloodiest known incident of unrest in China since the massacre that ended the Tiananmen Square protests in 1989 embarrassed China's president, Hu Jintao, into skipping the G8 summit in Italy. That is not surprising. Though distant from Beijing, the unrest in Xinjiang calls into question basic assumptions about China made by both the government and foreign investors: that Chinese citizens are ready to trade political dignity and fairness for economic progress and wealth; and that irrational forces, such as religion and ethnic nationalism, are distractions that can be bludgeoned away to enable the smooth technocratic transformation of society.

## You're no Dalai Lama, Ms Kadeer

The Uighurs' plight is like that of the Tibetans: unfairness is not a side issue. Like the anti-Chinese riots last year in Lhasa, Tibet's capital, the savagery in Urumqi shows that modernisation does not always dampen resentment against Chinese rule. For both the Uighurs and the Tibetans, economic development has been inseparable from immigration by ethnic-Han Chinese, 92% of China's population. But the two minorities present very different problems for the Beijing regime.

The Uighurs have never captured the West's attention in the way that Tibet has. While the saintly Dalai Lama has won the Nobel peace prize and become a friend to Hollywood stars, few outside the Islamic world have heard of Isa Yusuf Alptekin, exiled head of the Islamic Republic of East Turkestan, who died in 1995, aged 94, or of Rebiya Kadeer, a Uighur businesswoman who is the movement's new figurehead. The Chinese have also managed to persuade foreigners that the protests in Xinjiang are linked to jihadist terrorism: there are connections to the Taliban in Pakistan and Afghanistan, and almost two dozen Uighurs have spent time in Guantánamo Bay.

Although Tibet has garnered more headlines, the Uighurs probably represent a greater threat to the

regime in Beijing. An uprising in western Xinjiang around Kashgar in 1990 was swiftly put down; pro-independence protests in 1997 led to bloodshed, and last year there were several terrorist attacks, including one in Kashgar in which 17 policemen died. The Uighurs' resentments also have the scope to inflame Muslim sentiment not just in China (which has more Muslims than Saudi Arabia) but throughout the Islamic world.

The rioters were obviously not terrorists, so China has tried to make a scapegoat out of Ms Kadeer this time. But the idea that this revolt was planned seems fanciful. The pent-up anger vented on the streets of Urumqi was chaotic, ignited by reports of the deaths of at least two Uighur toy-factory workers after they had been falsely accused of rape. The violence in Xinjiang was crude, racist stuff on both sides, with the Han Chinese suffering the brunt of it.

The fighting was nasty enough in itself, but its underlying causes should worry Beijing even more. Many Uighurs believe their land, traditions and religion are being swamped by decades of Han immigration, which has seen the proportion of Uighurs in Xinjiang shrink from about 75% in 1949 to 45% now. They are less likely to advance in the civil service, and many feel that Han Chinese do better in business too. They are fed up with their lot as despised, second-class citizens. Like Tibetans, Uighurs feel colonised, as Xinjiang's natural resources—it is rich in oil and gas—benefit the rich coastal regions. Meanwhile, for some Han Chinese, the Uighurs seem ungrateful and backward, pampered by the state with preferential policies, such as being allowed to have more children.

These prejudices are fed by another Chinese failing: the habit of secrecy and censorship. Lies and partial truths spread fast. Confronted with a choice of ugly rumours—as about the toy-factory case—many are inclined to believe the ugliest. At least China seems to have learnt from the riots in Lhasa last year: the ethnic-Tibetan violence against innocent Han Chinese got less coverage than China's repressive response. This time, China allowed foreign reporters into Urumqi.

That aside, China's response to the Uighur revolt has been pretty standard. It poured troops in, rounding up hundreds of people and putting them behind bars. If the past is any guide, many will be detained for months; some will be tried and sentenced to death. China will blame an evil minority at home and abroad. It will make no attempt to acknowledge—let alone redress—the grievances behind the outburst. Tibet and Xinjiang will be suppressed as if they were unruly colonies.

## The perils of disharmony

But is this sustainable? Tibetans and Uighurs are only two of the groups which may not accept the growth-for-freedom trade-off that China's government offers. There are the unknown numbers of adherents to the Falun Gong movement; tens of millions of Christians who cannot follow their faith freely but already probably outnumber the 75m members of the Communist Party; farmers who have been victims of local-authority land-grabs; and many young who, unlike their parents, take economic prosperity for granted and are frustrated by the restrictions on their liberty.

By resorting to repression, Beijing can easily contain the disruption in Xinjiang. Despite its xenophobic propaganda, the integrity of the People's Republic's territory is not under threat. But something just as important is: the harmony which the government espouses as China's greatest national value, and without which the regime will find it harder to survive.

Economist.com OPINION LEADERS

The great public-sector pension rip-off

# Dodging the bill

Jul 9th 2009
From The Economist print edition

**It is time to recognise the full costs of public-sector pension schemes to the rest of us**

Illustration by Belle Mellor

JOIN a private-sector company these days and you will be very lucky if you get a pension linked to your final salary. In Britain almost three out of four companies that retain such schemes have closed them to new employees. The cost of paying such benefits, which are partly linked to inflation and offer payouts to surviving spouses, is simply too high now that many retirees are surviving into their 80s.

Yet most new public-sector employees in Britain and America continue to benefit from pensions linked to their salaries. The pension costs facing the public sector are roughly the same as those facing the private sector; their employees are likely to live just as long. But because of the presumed largesse of future taxpayers, governments seem under much less pressure to reduce their pension costs. In 2005 a reform package in Britain raised the retirement age for new state employees, but still left existing employees able to retire at 60.

Perhaps the real reason why public-sector pension costs have not been tackled is that the full bill has never been revealed to taxpayers. Calculating the cost of a pension scheme depends on two key assumptions. The first is the potential longevity of the employees; the second is the discount rate applied to future benefits. The higher the discount rate, the smaller the liability appears to be. There is a lot of debate about the right discount rate to use, but the conservative approach is to take the cost of government borrowing. Use that rate, and the liability of American state and municipal pension schemes may be $3 trillion—three times the value of all the authorities' existing debts. In Britain the liability adds up to 85% of GDP.

Even if that figure overstates the problem, there is little doubt that governments are understating their pensions liabilities. When workers in Britain are transferred from the public to the private sector, they are entitled to keep their pension rights; employers who take them on find that their pension costs are around double those estimated by the public sector. The fudge seems likely to continue. A consultation document sent out by the British government suggested that, rather than raising taxes or cutting spending, local authorities should fall short of fully funding their pension liabilities in the short term.

## Public affluence, private penury

There may be an argument for giving some public-sector workers, such as the police or the armed

services, higher pay and benefits in the form of pensions. But the cost should be fully accounted for. Today's opaque pensions system is unfair to private-sector workers, who suffer a triple whammy. First, most are now enrolled in riskier defined contribution (DC) pension schemes, where payouts depend on investment performance. Second, employers make smaller contributions to DC schemes than to final-salary plans, so pensions are likely to be lower. And third, as well as shouldering more of the burden for their own retirement, private-sector workers pay for public-sector pensions via their taxes. There is, in effect, a hidden transfer from private-sector workers to their public-sector peers. In Britain it may amount to as much as 30% of pay.

When the full costs become apparent, taxpayers may demand reform. Cutting costs is not easy: the bulk relate to promises already made. But raising the retirement age for public-sector workers in order to reflect increased life expectancy would be a start. Moving to DC pensions for new entitlements, or to a cheaper version of a defined benefit scheme (such as an average- rather than a final-salary pension) would also help. The greying of the American and British populations will inevitably involve some costs. It would be unfair if the burden was borne disproportionately by private-sector workers.

**India's budget**

# Have a little more patience with Mr Mukherjee

Jul 9th 2009
From The Economist print edition

**Though not as bad as investors think, India's budget leaves the government with a lot to do**

AFP

INVESTORS were not impressed with the budget which India's new government presented on July 6th. They expected bold reforms to hasten the country back to its recent 9% annual growth rate. But, in Bengali-accented English, Pranab Mukherjee, the finance minister, promised money to indebted farmers, middle-class taxpayers and infrastructure projects. He had less to offer investors. At best he scrapped a couple of nuisance taxes and promised to increase "people's participation" in state-owned companies—meaning "disinvestment", which Indians use to describe partial privatisation.

A euphemism for a euphemism for liberalisation was less than the markets wanted. The Bombay Stock Exchange had risen steeply since the Congress party won re-election in May, but as Mr Mukherjee resumed his seat in India's Parliament it tumbled by almost 6%.

Even the economists in Mr Mukherjee's own ministry accept that India will sustain rapid growth only if it can undertake radical reform. In a sweeping analysis last week, they urged the government to reform labour laws; generate 250 billion rupees ($5 billion) a year through selling stakes in its enterprises; allow more foreign direct investment, deal with entrenched subsidies, tackle its energy market, promote competition and more. Although some of that was beyond any budget, let alone Mr Mukherjee's, he omitted most of it. How harshly should he be judged?

The investors' frustration is understandable. With the West in recession, India's growth rate of 6.7% this year, according to the government's possibly hopeful projection, looks uncommonly good. Congress's return to power, at the head of a more stable and less left-wing coalition government, fuelled the optimism. Many expected Congress, unencumbered by its former communist allies, to introduce the liberal changes upon which India could base its return to 9% growth.

Yet that is to misread the politics. Though less rabid than its former communist allies, Congress is still left-leaning and undecided on reform. Its prime minister, Manmohan Singh, pioneered India's creeping reform process as a visionary finance minister in the early 1990s, but he is beholden to his pragmatic party chief, Sonia Gandhi. And as Mrs Gandhi knows, Congress was returned to power with a mandate that did not include liberal reform, which most Indians mistrust.

## Three steps in the right direction

Set against more realistic expectations, the budget was only mildly disappointing. Mr Mukherjee, the

government's wiliest political fixer, thus deserves a little patience. What he says matters less than what he does. There are three things to look out for.

The first is whether Congress honours the few reforms Mr Mukherjee was bold enough to volunteer. He must increase the efficiency of the fertiliser subsidy, which last year cost 758 billion rupees, or about 1.5% of GDP, by paying it directly to needy farmers instead of lucky fertiliser makers. India needs a nationwide goods and services tax by next April. The government must also sell stakes in engineering works, mines, fertiliser factories and other state-owned companies—and on the scale that its advisers recommended.

All this will help with Mr Mukherjee's second test—to shore up the public finances. India's slowdown is chiefly the result of lower private consumption—its contribution to growth fell by half last year. Handouts to consumers through tax cuts and welfare spending thus make sense in the short run, so long as India's already-stretched public finances are repaired when the crisis abates. Yet after a 36% increase in government spending in this budget—following last year's election budget and three stimulus packages—the fiscal deficit is estimated to be around 12% this year, including "off-budget" items. This should worry Mr Mukherjee much more than he let on. His failure to outline how and when to redress the deficit spooked some investors more than his reticence on reform.

The third test is of Mr Mukherjee's will. Politics prevented him from adopting his advisers' wish-list in the budget, yet in post-budget interviews he nevertheless endorsed it as his own. Does the canny Mr Mukherjee hope to achieve more liberal progress than he has so far promised? This would be the real prize for investors.

Economist.com OPINION LEADERS

Regulating banks

# Appetite suppressant

Jul 9th 2009
From The Economist print edition

**Capital rules now seem the only way to tame the banks. They will need to be tighter than in the past**

Illustration by Peter Schrank


BANKS and free lunches traditionally go together. Lenders are run for private benefit, but taxpayers underwrite them if things go wrong. Yet the scale of support that has been extended in the current financial crisis is unprecedented: the entire system has been explicitly guaranteed. Even as unemployment soars, bankers are talking again of big bonuses and a "war for talent". The woeful legacy of the crisis could be a supersized banking system gorging on the taxpayers' tab.

Regulators want to prevent this, and their tool of choice now seems to be tighter capital-adequacy rules. This week Britain announced reforms that put a strong emphasis on capital (see article), and other countries are expected to do the same in the coming months. Even though banks have often found their way round such rules in the past, this approach probably makes sense for two reasons.

First, it reflects the lack of alternatives. Governments have turned away from the really radical options for reform because there is no easy way to resolve society's desire for cheap and efficiently delivered credit with its wish for stability. Breaking up the biggest banks might not make them safer, and politicians seem not to have the stomach for the fight it would entail. Taking the banks into public ownership, to be micromanaged by politicians, has obvious drawbacks too.

Second, capital, the buffer between banks' assets and liabilities, is indeed at the heart of the problem. The bigger that buffer is, the safer a bank is likely to be. Low levels of capital ordinarily frighten off creditors but state guarantees give depositors and others every reason to keep financing the banks. If governments cannot retire these guarantees—and doing so is not credible given the crisis—they have to mandate higher capital.

## Tougher, craftier and more creative

What should capital rules try to achieve? First, they can expand the system's buffer to a level which protects taxpayers from losses. The existing Basel 2 rules proved to be too lenient. Regulators now have a better idea of how much capital is needed to survive a meltdown. Heading into the crisis, America's banks would have needed at least double the present minimum core-capital ratio of 4% to have avoided raising equity or breaching that floor at the bottom of the cycle (see article). The broad outcome is clear: as the economy picks up, capital must be built up substantially from the low it is likely to hit in 2010. The rules must be global, ideally in the form of a new Basel regime, to prevent activity migrating to laxer

countries.

Banks complain that equity is expensive and that they will have to raise the price of loans. By how much is unknown: even if banks' borrowing costs are insensitive to their capital levels, shareholders may accept lower returns in exchange for the lower risk provided by a bigger equity base. But it is an illusion that taxpayers can avoid pain in a guaranteed system. They can either have cheap loans and pay for bail-outs, or pricier loans and bigger buffers. Society clearly prefers the latter.

Second, the new capital regime must be harder to game. Basel 2 failed not just because it set the level of capital too low, but also because the definition of capital was too lax: banks were allowed to include certain types of debt. To start with, the new regime must admit only pure equity as capital. Although there are novel proposals to use insurance policies and convertible debt as capital, the immediate priority should be simplicity.

Third, regulators need to be craftier when estimating the hit that capital must absorb. Rather than "snapshots" of banks' balance-sheets, which are riddled with accounting quirks, they should use rolling "stress tests" that try to capture losses over several years, taking into account off-balance-sheet activities as well as banks' core profits. The results of these tests should be made public. If this requires teams of supervisors to camp inside banks, as is the case today in Spain, so be it.

Finally, national regulators need to be creative and use capital surcharges over and above the global minimum standard to "fine" banks that pose a bigger threat to taxpayers. There is a risk that the blunt tool of capital will be asked to do too much: fine-tuning pay policies, for example, and discouraging certain types of trading. But the broad objective must be gradually to prod banks to shrink and improve their liquidity.

Can banks be tamed by capital rules? Nobody really knows. But capital is the only civilised option left in the regulatory toolbox. If it cannot be used to protect taxpayers from losses, or it fails to persuade banks to reform themselves, there will be popular pressure for more violent forms of intervention. Banks greatly underestimate this risk. They are enjoying a free lunch—in the last chance saloon.

## Mexico's mid-term election

# The perils down south

Jul 9th 2009
From The Economist print edition

**Mexico is in trouble; one way out would be for Felipe Calderón and the PRI to join forces**

Reuters

OVER the past decade Mexico may not have enjoyed explosive economic growth, but it has achieved something equally valuable. As it has transited rather painlessly from seven decades of rule by the Institutional Revolutionary Party (PRI) to a competitive democracy, the country has discovered a new stability. Problems and poverty remain, but thanks partly to the much-maligned North American Free-Trade Agreement (NAFTA) linking Mexico's economy to those of the United States and Canada, there was quiet progress. Most Mexicans can now claim to be middle-class.

This stability looks in jeopardy. A crackdown on drug-trafficking, launched by Felipe Calderón after he narrowly won the presidency in 2006, has provoked a wave of violence. Albeit fairly localised, this shows no sign of subsiding. Efforts to create a new, uncorrupt police force are moving very slowly. Worse, Mexico has been deeply hurt by recession, mainly because much of its industry is tied to the sickest segments of the American economy—cars and construction—while its migrant workers north of the border are sending less money home. And now swine flu has knocked out the tourist industry. The economy is set to shrink by around 6% this year. Unemployment is soaring. Migration to the United States no longer offers a safety valve: crossing the border has become riskier, and those who make it have little prospect of a job.

Unlike the last deep recession in 1994-95, this one was not caused by Mexico's own mistakes. But that is little comfort. Last time the economy bounced back quickly. That may be harder now. Border security checks are slowing trade flows; violence may discourage foreign investors. At home, public and private monopolies dominate activities from energy to telecommunications and education, caging animal spirits. Mexico has slipped down the world rankings of competitiveness.

None of this means that Mexico is about to become a failed state, as some analysts in Washington have suggested. But the country does risk losing its hard-won stability. The recession has blown a hole in the public finances. Because of the gross inefficiency of Pemex, the state oil monopoly, oil output is plunging. Mexico may soon lose its cherished investment-grade credit rating. If the recession drags on, the risk of social turmoil will rise. The worry is that economic and sociopolitical instability may start to feed on each other.

Despite all this Mr Calderón remains popular. He is a decent man doing a difficult job. (His weakness has been to fill too many senior posts with lacklustre people.) He has pushed through modest reforms of energy and education. But that was not enough for his party to avoid defeat in last Sunday's mid-term election (see article). The PRI and its allies now have a majority in the lower house of Congress—which writes the budget—whereas the president's party will lack the numbers to veto legislation. This hardens

political deadlock.

## America should help too

Mexico cannot afford three more years of political drift. Mr Calderón should invite the PRI to join a government of national unity to force through some long-overdue measures, including tax reform, a further energy reform to bring in private investment, a more powerful competition authority and the adaptation of the constitution to democracy. The PRI has a powerful incentive to collaborate. In 2003 it won a mid-term election by a similar margin. Confident of a return to the presidency, it played a spoiling role in the following legislature only to come third in the 2006 election. A display of statesmanship could persuade Mexicans that the PRI deserves to be granted executive power again.

In all this the United States is more than a bystander. What happens in its populous southern neighbour is of vital interest. Barack Obama has said that America should do more to halt the southward flow of guns and laundered money to the traffickers. Indeed it should. It also needs to spend more on infrastructure to speed legal trade across the border. Economic integration may seem like a disadvantage now. But it can speed recovery and help Mexico hang on to its imperilled stability.

# On the Elgin marbles, Romano Prodi, clearing houses, wine, drugs, fund management, voters, meritocracy

Jul 9th 2009
From The Economist print edition

## Rocks of ages

SIR – I chuckled at your use of the term "moral clarity" when describing the Greek request that the British Museum return the Elgin marbles to Athens ("Snatched from northern climes", June 27th). Athens was the force behind the Delian League of Greek city-states in the 5th century BC, which was founded to provide money for the common defence against Persia. The funds raised, however, did not go towards defence but were used by the Athenians to pay for expensive building projects on the Acropolis, including the Parthenon. The city-states that did not want to pay were conquered and their citizens became subjects of Athens. The league was no longer a mutual protection pact; it was "the cities that the Athenians rule".

The classical Athenians extorted money to craft what have become known as the Elgin marbles; now their descendants want the works returned to them. I propose instead that the marbles be returned to the descendants of the people who helped pay for them in the first place, and who now live in the Delian League's former cities along the eastern Aegean. For moral clarity, the Elgin marbles should be returned to Turkey.

Robert Ingle
Corvallis, Oregon

SIR – The Parthenon and its marbles are not like other monuments. They define classical Greece. Do not deny Greeks the right to restore their ultimate landmark. Would Stonehenge, the Taj Mahal and the Statue of Liberty be the same if parts of them were permanently dispersed in various museums?

Ilias Tagkopoulos
Davis, California

SIR – I have read arguments for and against the return of the Elgin marbles hundreds of times. I am tired of such debates. As with any work of art coming from any historical period there is a legal owner, be it the Greek government or the British public. Greek politicians have to understand that most people are not fooled by rhetorical speeches. Had there been a real legal argument supporting the return of the marbles to Greek soil, they would be in a Greek museum by now.

Andreas Heraclides
London

SIR – I am glad to see that the case against the reunification of the marbles has started to focus more on pragmatic considerations rather than arguments drawing on long-discredited ideologies. But the real risk is not that the Greek claims, boosted by the new Acropolis Museum, will discourage lending programmes between museums. The real and practical worry is that the refusal of the British Museum to discuss the issue seriously will give the wrong message to those tempted to exploit current political circumstances in order to misappropriate cultural treasures and destroy their integrity.

Nikolaos Diamantis
Nottingham

* SIR - The Ottomans who occupied Greece at the time had no more right to sell or give away the marbles to the British than the occupying Nazis did when they looted the museums and private collections of Europe. However, your idea that museums should lend their treasures is, I think, a good one. Perhaps if the British Museum were to acknowledge Greece's rightful ownership of the marbles then the time may come when Athens could lend the sculptures to other museums including the British Museum.

Kyriacos Kyriacou
London

## My time in Brussels

SIR – In his analysis of the process by which the new president of the European Commission is to be chosen and looking back at my performance in that job, Charlemagne called me “clever but incoherent” (June 27th). It is not for me to comment on whether or not I was clever. As for my incoherence, it may well be that I was unable to express myself fluently. But my missed chance of a second term in Brussels had less to do with form than with substance. My ambition was to lead European leaders into endorsing leaps forward in European Union integration that I deemed necessary to stand up to the challenges that history and globalisation were placing before all of us. These included the enlargement that took in east European countries, a deep institutional reform, and economic co-ordination in the euro area.

A clash was inevitable with the more nationally minded and deeply Eurosceptic among European leaders (the British prime minister of the time was the most intelligent and eloquent of them all) who would not tolerate the boss of the commission taking the lead.

Romano Prodi
Former president of the European Commission
Bologna

## Reducing a risk

SIR – Your article on clearing houses concludes that if the benefits of central counterparties in over-the-counter (OTC) markets are so overwhelming, “why did they not emerge on their own?” (“Counter insurgency”, June 27th). The answer is that they did, a decade ago. LCH.Clearnet has been successfully clearing OTC interest-rate swaps for ten years. The service has been developed in collaboration with the interdealer banks, an integral and essential part of the default management process that successfully dealt with Lehman Brothers’ $9 trillion interest-rate swap default within three weeks of the default and at no loss to the clearing house or other market participants.

Clearing is not a panacea and it is not intended to replace banks’ risk-management procedures, but it does add an additional level of protection. The Lehman default demonstrated both the systemic value of clearing and the effectiveness of all the clearing houses involved in managing risk. Your suggestion that clearing houses are not capable of effectively clearing OTC products has simply been proved wrong by recent events.

Roger Liddell
Chief executive
LCH.Clearnet
London

## Wine tasting

* SIR - Your article on packaging wine in cartons used logic and science that is too clever by half (“Box clever”, June 13th). We agree that “packaging plays a role in controlling wine chemistry and taste” and that the plastic liner in boxed wine allows “flavour-destroying oxygen to seep in during storage”. Yet now researchers say the migration of wine and oxygen through the plastic is somehow a good thing because it ameliorates one relatively minor problem with ladybirds.

Countless generations of vintners have tried to keep oxygen from wine. If wine in a bag were that good, logic dictates that all vintners who care about the taste of their wine would choose that storage method. The fact that glass is best for “great wine” just proves it is best for all wines.

Why? Because only glass is completely inert. It can’t mix with the wine and it keeps oxygen out. It has been with us for 3,000 years and has proven to be safe not just for wine but for all food storage. And unlike boxed wine, glass packaging is truly 100% recyclable.

Joseph Cattaneo
President
Glass Packaging Institute
Alexandria, Virginia

## Legalising drugs

SIR – It is clear that the argument for ending the failed prohibition of drugs is approaching a tipping point ("At last, a debate", June 27th). The fact that the United Nations "drug tsar" tried to refute the evidence for legalising drugs on page one of this year's UN annual report on drugs shows that the prohibitionists are concerned with the increased attention being paid to reform in recent months.

As a retired police officer who for 34 years helped fight the "war on drugs" and witnessed its failures, I find it curious that the UN frames prohibition as an effective drug "control" strategy and implies that legalisation would weaken control. Actually, legalisation would move drugs away from the out-of- control cartels and gangs who traffic in them now and into a properly regulated system.

Norm Stamper
Seattle chief of police, 1994-2000
Seattle

## Pensions

* SIR - It is heartening to see that you understand the perverse incentives and information asymmetries that characterise fund management ("Wasting assets", June 20th). In Australia, we are all too aware of these problems, with our mandatory, predominantly defined-contribution, superannuation fund system. We commissioned research that found Australian retail superannuation funds achieve returns up to 2% per year less than their not-for-profit, independent counterparts.

Much of this discrepancy can be attributed to commissions and fees paid by the providers of retail products to their distribution networks. Another factor is the bargaining power of the big not-for-profit funds and their appetite for more illiquid, unlisted assets.

The Australian experience demonstrates quite clearly that retail investors are not the rational, fully informed agents economic theory might suppose. Independent, not-for-profit trustees acting on their behalf can make the market for fund-management services work the way it should-in the consumer's favour.

Andrew Barr
Policy and research manager
Australian Institute of Superannuation Trustees
Melbourne

## Concentration or dilution?

SIR – Your article on America's Voting Rights Act did not mention an important reason underlying the establishment of congressional districts that are majority African-American ("Sacred, or outdated", June 27th). Such districts make it easier to elect conservative Republicans and Democrats in the surrounding areas.

Daniel Vogt
Jackson, Mississippi

## Network power

SIR – Like many others you make the dangerous assumption that meritocracies are a good thing ("Insider out", June 27th). Companies obviously need effective people, but one can think of many

instances in history where lazy, obstinate, bloody-minded non-participants have been, or would have been, highly valuable.

As for intelligence, it is not at all desirable for a person's social status and power to reflect their mental abilities. This is a monstrous idea.

Jon Geidt
Cape Town

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* Letter appears online only

Economist.com BRIEFINGS

The riots in Xinjiang

# Is China fraying?

Jul 9th 2009 | BEIJING, KASHGAR AND URUMQI
From The Economist print edition

**Racial killings and heavy-handed policing stir up a repressed and dangerous province**

EPA


IT BEGAN as a protest about a brawl at the other end of the country; it became China's bloodiest incident of civil unrest since the massacre that ended the Tiananmen Square protests 20 years ago. The ethnic Uighurs in the far western city of Urumqi, the capital of Xinjiang province, accused Han Chinese factory workers in the southern province of Guangdong of racial violence against Uighur co-workers. By the time Urumqi's Uighurs had finished venting their anger, more than 150 people were dead and hundreds more injured.

Much is still unknown about what happened on the afternoon of July 5th. A protest by several hundred people in the city's central plaza, People's Square, moved southward into Uighur areas, including the Grand Bazaar, a large shopping centre. Somehow—perhaps, overseas Uighur activists say, because the police opened fire—it became an explosion of anger, in which random Chinese were clubbed and stoned to death.

Xinjiang is no stranger to unrest among its more than 8m Uighurs (about 45% of the population according to official figures, which tend to undercount Han Chinese migrants from elsewhere in the country). Many Uighurs resent rule by China, which they accuse of trampling on their Muslim Central Asian culture. It is not clear why the police failed to stop the killings, nor how many of the deaths were caused by the security forces themselves. Uighur exiles gave far higher estimates of the numbers killed, which they said included many Uighurs.

The suddenness and scale of the violence, and its racist nature, were reminiscent of rioting in Lhasa on March 14th last year that triggered sympathetic protests by Tibetans across the Tibetan plateau. The government fears that Xinjiang could face a similar convulsion. Both Tibet and Xinjiang are sparsely populated, with vast areas of mountain and desert. But together, and including Tibetan-inhabited areas bordering on Tibet proper, they make up 40% of China's territory—in an area of enormous strategic importance, bordering on South and Central Asia.

Chinese officials were quick to accuse an overseas group, the World Uighur Congress (WUC), of having "masterminded", "instigated" and "controlled" the unrest in Urumqi, but have yet to offer proof. They have particularly attacked the WUC's leader, Rebiya Kadeer, a former member of Xinjiang's political elite. Ms Kadeer was one of the region's wealthiest entrepreneurs until she fell foul of the authorities because of her sympathies with Uighur nationalism and spent six years in prison on state security charges. She now lives near Washington, DC.

Remarkably for an incident so politically sensitive, the authorities let foreign journalists go to Urumqi to cover the aftermath. (After last year's unrest in Lhasa, Tibet was all but barred to foreigners, journalists included.) The government was also unusually quick to provide casualty figures—156 dead as *The Economist* went to press, and another 1,080 injured. It seemed confident that journalists would confirm official accounts suggesting that those killed were overwhelmingly Hans. But oddly, since hospitals keep records of the ethnic origin of patients, the authorities have provided no racial breakdown.

Foreign journalists who arrived on July 6th found the riot area full of broken shop windows, fire-damaged buildings and scores of burned-out cars. The manager of a car showroom said several hundred rioters had attacked his business late on Sunday night, damaging or destroying more than 50 vehicles. Among the dozens of riot victims admitted to the nearby Urumqi Friendship Hospital was Huang Zhenjiang, a 48-year-old Han-Chinese taxi driver, who described how he was attacked by rioters with stones and clubs at the end of his shift. It was, he said, "terrifying" and "unimaginable". Many residents spoke of rioters smashing rocks on the heads of victims as they lay on the ground, and even cutting off a girl's leg.

The authorities may have been remarkably inept at preventing and curbing the violence (especially since, as officials admit, they had evidence that a protest was being planned). But they were swift to start rounding up suspects once the rioting had died out later that night. More than 1,400 people have so far been arrested. Urumqi's Communist Party chief, Li Zhi, said those who had used "cruel means" during the rioting would be executed. Xinjiang's governor, Nur Bekri, who is a Uighur, said officials would use "all means" to maintain control in the city.

They failed. On July 7th thousands of young Han Chinese rampaged through the streets, calling for vengeance against Uighurs for the earlier riot. "This is no longer an issue for the government," said one man, with a club in his hand. "This is now an ethnic struggle between Uighur and Han. It will not end soon." Carrying meat cleavers, axes, clubs and shovels, Han demonstrators roamed in packs of 20-200, swiftly changing direction whenever someone claimed to have spotted a Uighur. "Kill Uighurs!", they cried. "Smash Uighurs!" and "Unity!" One self-styled leader called out, "Don't break things!" as he exhorted a large group towards an area surrounding a mosque. His call was met with cries of "Don't smash things, smash Uighurs!" Police often made only half-hearted attempts to stop these crowds.

More unrest boiled up on July 8th, even as President Hu Jintao flew home before the G8 meeting in Italy to handle the crisis and thousands more armed riot police poured into Urumqi's city centre in trucks, troop-carriers and marching ranks. Many Urumqi residents believe the new arrivals, though kitted out as members of China's paramilitary police force, include regular army troops. Groups of angry Han Chinese, mostly unarmed this time, ignored government warnings to stay at home. They surrounded one-on-one fights between Hans and Uighurs and urged on the Hans. Crowds also snatched away Hans who had been detained by the police and set them free.

## Closing the mosque


The Uighur side of the story has been slower to emerge. Many Uighurs dismissed the government's account that the July 5th riot was part of a separatist plot. But very few—such was the terror of police or Han recrimination—were willing to say much. One Uighur owner of a clothes shop, who claimed to have witnessed the riot from the beginning, said it started as a demonstration calling on Xinjiang's governor to come out and talk about what had happened in Guangdong. In the fracas there on June 25th, Han Chinese workers had accused Uighurs of rape. At least two Uighurs were killed in the fight.

After about 90 minutes the police told Urumqi's protesters to leave, said the man from the clothes shop. The police then began shoving and pulling demonstrators who refused to go. When some Uighurs responded by smashing windows, the police used greater force, beating people and firing their weapons. Violence by Uighurs then began to flare across the city.

The response to the rioting elsewhere in Xinjiang has so far been less explosive than the authorities feared. On July 6th in Kashgar, 1,080km (670 miles) south-west of Urumqi, a group of Uighurs tried to stage a protest in front of Idh Kah mosque, a city landmark. Two Western tourists who witnessed the event said as many as 100 people took part, shouting slogans and jabbing their fists in the air. Security

forces dispersed the gathering in less than an hour, without obvious violence, and took away several protesters. The plaza in front of the mosque was sealed off by riot police carrying clubs, and the mosque was closed.

The authorities may well have been better prepared in cities like Kashgar. These places have more of a history of Uighur unrest than Urumqi, which has long been dominated by Hans. The police say they have “clues” that efforts have been made to organise protests in Aksu and Yining. Yining, on the border with Kazakhstan, was the scene of rioting in 1997.

The likelihood is that, as in Tibet, the authorities will clamp down hard, and that this will fuel anger across a broad swathe of the population. Xinjiang’s most powerful official is a Han Chinese, Wang Lequan, who is also a member of the ruling Politburo in Beijing. He has held the post of Xinjiang’s party chief since 1994, outranking Nur Bekri, and has impressed fellow Chinese leaders with his tough approach to Uighur nationalism. (One of his deputies, Zhang Qingli, went on to become party chief of Tibet in 2005, an appointment that, in Tibetan eyes, doomed any prospect of a softer government hand in their region.) President Hu is no liberal on such issues himself. As party leader in Tibet in the 1980s, he imposed martial law in Lhasa after protests there in 1989.

Repression had already been stepped up in Xinjiang long before the rioting. The escalation dates back to the launch of America’s anti-terror campaign in 2001. China then began linking long-simmering separatist tensions in Xinjiang with the same forces of extremism that America faced. It said one Uighur group, the East Turkestan Islamic Movement, was part of al-Qaeda. America backed this assertion, but Western human-rights groups said there was little evidence of al-Qaeda’s involvement in Xinjiang. China was playing up the connection, they said, in order to justify harsher measures against Uighur nationalists.

Twenty-two Uighurs were indeed caught by the Americans in Afghanistan and sent to Guantánamo Bay. Four of them were freed in June and resettled in the Bahamas. The Pacific island of Palau has offered to take 13 others. The Uighurs insist they were not involved in any anti-American operations in Afghanistan. But their capture helped to bolster China’s argument that it too faced an organised terrorist movement backed by foreigners, even though occasional attacks in Xinjiang hardly seemed well organised. Only primitive weapons were involved in the two bloodiest incidents last year that were blamed on terrorists—one against police in Kashgar that left 17 officers dead in August, and bombings in Kuqa the same month that killed two people. Suicide attacks, a hallmark of Muslim militancy elsewhere, are hardly known in Xinjiang.

## Economic jealousies

Since 2001 the authorities have banned private visits to Mecca and insisted that those making pilgrimages there must go on organised tours. The authorities have tightened controls on mosques in Xinjiang and rules that ban children from receiving religious education. They have warned students and civil servants not to observe Ramadan. A group of Uighur women staged a protest in Khotan last year against local government efforts to ban head coverings. (The *niqab* is often seen in Xinjiang, especially on older women.)

But there is little evidence that Xinjiang’s Muslims have been widely affected by extremist movements elsewhere in the region. In the rioting in Urumqi, racial discrimination is likely to have been a bigger source of grievance than religious repression. Uighurs have faced more such discrimination in the past year as a result of security measures in the build-up to the Olympic games in Beijing in August. Police harassed Uighurs then because of their perceived potential links with terrorism. Hotels had to report the registration of Uighur guests to the police.

Security is again being tightened across China as the authorities prepare to celebrate the 60th anniversary of the country’s founding on October 1st. This will involve a huge military parade through central Beijing, which the authorities fear could become a target for discontented minorities. The event coincides with the 60th anniversary of communist rule over Xinjiang. Even without Urumqi’s unrest, Uighurs had been likely to feel the pressure as the celebrations draw near.

AP

**How Hans dominate these days**

Economic factors come into play, too. Many Uighurs resent what they see as the business advantages enjoyed by Han Chinese immigrants, whose clan, commercial and political networks extend across China. The recent economic crisis may have exacerbated problems faced by Uighur migrant workers in other parts of China, such as those in the skirmish in Guangdong. Millions of people have lost their jobs as a result of China's recent export slump.

Many Uighurs feel that their culture is being threatened by a massive influx of Han migrants in recent years. China has stepped up investment in the western region to give the area a greater share of the prosperity that the east has enjoyed. The government denies it is trying to change the ethnic mix of Xinjiang, but Uighurs complain that Hans have enjoyed the lion's share of dividends from the investment drive. Some of them also worry about China's efforts to promote the use of Mandarin in Xinjiang's schools. Uighurs complain that the Han Chinese tend to look down on them as uncultured ruffians. The violence in Urumqi is likely to reinforce both these stereotypes—and the Uighurs' vivid sense of alienation.

## Who to talk to?

After the unrest in Tibet, China could at least placate Tibetan and Western opinion by talking to the Dalai Lama. It failed to pursue this option effectively, holding three rounds of discussions with the Dalai Lama's representatives but offering no concessions. In the case of Xinjiang, China is even less likely to open a dialogue.

Ms Kadeer, the figure with greatest clout among the Uighur diaspora abroad, also commands some respect in Xinjiang itself. But she has been so vilified by China that contact is barely imaginable. She also lacks the Dalai Lama's political clout. Nicholas Bequelin of Human Rights Watch, an American NGO, says she is hardly known in the Xinjiang countryside. China's official media have heaped scorn on what it says are her ambitions to gain the kind of respect that the Dalai Lama enjoys in the West. Even though President George Bush met Ms Kadeer in 2007, few outside the Uighur nation have heard of her.

With the West itself preoccupied by the threat of Islamic extremism, China is even less reticent about cracking down in Xinjiang than it is in Tibet. Journalists have long been largely barred from visiting Tibet. But after the attacks of September 11th 2001 China became increasingly willing to allow foreign media to travel around Xinjiang, even without official permission (though some were still stopped by the police). It may have calculated that media visits would reinforce images in the West of a China beset by Islamist militancy. In Urumqi this week, the authorities set up a press centre and organised visits to affected areas for foreign journalists.

The government, however, was unusually quick to restrict internet and mobile telephone communications. It has been spooked by the role of the internet during recent unrest in Iran. The Iranian opposition has sparked considerable online discussion in China, as well as disapproving coverage in the official media. Within hours of the Urumqi riot, internet access was cut across Xinjiang (the first time such a wide outage has been reported anywhere in China, even during the unrest in Tibet). International telephone calls were blocked. Within 48 hours text-messaging services were also suspended. A few broadband lines were kept open in an Urumqi hotel for the media.

But China could be heading for the same spiral of anti-Western sentiment that followed the unrest in Tibet. Urumqi's unusual openness to foreign media contrasts with an outpouring of contempt for Western media coverage of the event in the Chinese press and on the internet. A similar response last year fuelled

nationalist anger among urban Chinese and strained China's ties with some Western countries. (A few foreign journalists in China received death threats because of their coverage of Tibet.) The Western media have been accused of being too sympathetic to the Uighur rioters. The *Global Times*, an ardently nationalist publication published by the party's main mouthpiece, the *People's Daily*, has been among the leaders of the anti-foreign-media charge.

Last year public anger over Tibet was particularly aimed at France, because of the disruption of an Olympic torch parade through Paris in April by pro-Tibetan protesters and a suggestion by President Nicolas Sarkozy that he might boycott the Olympics. Mr Sarkozy turned up in the end, but relations between China and France were soured for months, and were further aggravated by a meeting between Mr Sarkozy and the Dalai Lama at the end of the year. In the Xinjiang case, America is more likely to be in the line of fire as the host of Ms Kadeer, who sought asylum there after being released from prison on medical parole in 2005. China has long been grumbling about America's refusal to repatriate Uighur detainees at Guantánamo Bay to China because they might be mistreated.

China can count on strong moral support from its Central Asian neighbours, with which it is co-operating closely to try to combat cross-border militancy. In the old alleyways of Kashgar, now being rapidly torn down as part of an urban-renewal programme that is fuelling yet more resentment among local Uighurs, official painted slogans condemn Hizb-ut-Tahrir, an Islamic group calling for a universal caliphate. The group, which has roots across China's borders, has started to gain recruits in Xinjiang, but is not thought to be widespread. China's efforts to establish common cause with its neighbours, and to encourage them to stamp out Uighur militancy in their own territories, may partly explain the prominence that Kashgar's authorities give the organisation.

America feels these closer ties with Central Asian countries are being forged at its expense. But it appreciates China's quiet support for the anti-terror campaign, including intelligence-sharing. America has no interest in supporting Uighur nationalism and exacerbating instability in an already volatile region. Xinjiang for now is one unstable Muslim area of the world where America is not a public enemy, at least among its Muslim population. It will require a skilful balance between the preservation of crucial ties with China and support for the rights of an aggrieved minority to ensure that this remains so.

California's budget crisis

# Meltdown on the ocean

Jul 9th 2009 | LOS ANGELES
From The Economist print edition

**As the state's finances disintegrate, for many so does the California Dream**

AP


ALTHOUGH one would hardly know it from the antics of its politicians—or from its newspapers, which all this week were fixating on Michael Jackson's funeral rites—California is in as serious a condition as an American state can be. Legally unable to declare bankruptcy as a company would, the state has begun paying many of its bills with IOUs instead of cash. One of the three big credit-rating agencies, Fitch, this week downgraded the state's bonds, already the lowest-rated such bonds in the country, to BBB, within spitting distance of "junk". Government offices are closed on some days, as state workers take involuntary and unpaid furloughs. Taxpayers are still waiting for refunds. Poor people are afraid of losing their state-funded health insurance. Parents, fearing ever shabbier public schools, have another reason to think about moving out of state.

Meanwhile, the governor, Arnold Schwarzenegger, and the leaders of the legislature have been frantically scoring points off each other in Sacramento, the state capital. As the previous fiscal year drew to a close on June 30th, Darrell Steinberg, the Democratic leader of the Senate, and Karen Bass, the Democratic leader of the Assembly, were proposing some stopgap measures that would have saved a dollop in the new fiscal year and averted the issuing of IOUs. But the Republican governor, claiming to insist on all or nothing, said no. Overnight, the budget gap swelled to a staggering $26.3 billion and now grows by an estimated $25m each day.

Mr Schwarzenegger, affecting insouciance as he smoked his trademark stogies, got his team to prepare a mocking YouTube video with footage of a committee hearing about whether cutting cow tails for udder hygiene was inhumane. "Right now, in the midst of a budget crisis, they are debating about cow tails, and I think that this is inexcusable," Mr Schwarzenegger sneered, even as he chucked new reform proposals into the negotiations that are entirely unrelated to the current budget crisis.

Exasperated, Ms Bass, who had already backed off from any idea of raising taxes, muttered something about the lame-duck governor worrying more about "fixing his legacy" than the budget. On July 6th, she boycotted a meeting, demanding that Mr Schwarzenegger restrict the talks to just the budget crisis. As *The Economist* went to press, there was still no deal in sight.

California thus seems to be doing its level best to come to ruin and, as the nation's largest economy, to

drag the country's hopes for a recovery down with it. The recession was the trigger but not the cause of the current malaise, which stems, as Fitch put it when explaining its downgrade, from "the state's continued inability" to balance its budgets.

But what exactly does a crisis look like for an American state? "Falling off a cliff" is the usual metaphor but not an appropriate one, according to Ross DeVol, chief economist at the Milken Institute, a think-tank in Santa Monica. Instead of death on impact, he says, it is a matter of "who suffers in what order and how much?"

With luck the IOUs, officially called "registered warrants", will turn out to be more symbolic than apocalyptic, provided that banks accept them and that a budget deal arrives soon. The last time California paid with IOUs, in 1992, Bank of America was dominant in the state and kept order. This time many banks must play along, and several suggested this week that they would accept the IOUs only until July 10th. If that practice becomes widespread, bearers may have to wait until October to get their money. For some suppliers this may mean bankruptcy; for students, uncertainty over their college tuition; for consumers without tax refunds, austerity.

And if all this leads to more downgrades, California's borrowing costs will increase and the budget gap will further widen. But this does not automatically threaten the owners of California's "muni" bonds, since the state constitution dictates that schools be paid first, bondholders second and then everybody else.

It does, however, increase the pressure to balance the budget. New taxes are no longer being discussed, because California requires a two-thirds majority in both houses of the legislature to pass them, and the Republican minorities are large enough, and partisan enough, to block them altogether. This means that the budget must be balanced by cuts alone.

The largest part of the budget, and thus the biggest target for cuts, is education. Mr Schwarzenegger has proposed suspending a spending formula that voters explicitly chose at the ballot box. In response, the powerful teachers' union sent a gesture, in the form of 10,000 protesting postcards, to one of Mr Schwarzenegger's branch offices. But teachers and schools will suffer, which hurts children and thus parents.

The next largest part of the budget is the state's social safety net, including its health-care programme for the poor. Mr Schwarzenegger wanted to eliminate entire programmes wholesale, but now appears ready to settle for shrinking them. The debate, such as it is, is now about how many children will lose coverage, how many elderly Alzheimer's patients will stop receiving visits from nurses, whether to treat drug addicts and so forth.

The pain thus seems likely to flow to the bottom of the social hierarchy. But all Californians will notice. Their parks may close, their neighbourhoods may become less safe. "The Californian Dream is at least temporarily suspended," says Mr DeVol.

The economy and employment

# On the turn?

Jul 9th 2009 | WASHINGTON, DC
From The Economist print edition

**The gloom about jobs is overdone, but the outlook remains tenuous**

AFTER ebbing steadily since the start of the year America's monthly job losses figure abruptly jumped from 322,000 in May to 467,000 in June, deflating talk of an imminent exit from recession. Hand-wringing in Washington quickly followed. On July 5th the vice-president, Joe Biden, admitted that the White House had "misread how bad the economy was". In January it had predicted that unemployment would peak at 9% without a fiscal stimulus and 8% with one. The $787 billion two-year stimulus is now law but unemployment stands at 9.5% and Barack Obama admits it will probably top 10%.

At one level, the hand-wringing is overdone. The economy is doing a bit better than June's employment report suggests. Jim O'Sullivan of UBS argues that the early date on which the job-market survey was done, combined with fewer than usual summer jobs for students, exaggerated the weakness. He notes that stockmarkets, home sales and consumer confidence are all showing the gradual improvement typical of turning-points. The deep freeze in the financial markets is thawing: issuance of stocks and corporate bonds hit $338 billion in the second quarter, according to Thomson Reuters, the highest for a year.

The odds are that the economy will begin to grow again in the current quarter for two reasons: the dramatic inventory liquidation, which led manufacturers to slash output and payrolls starting in late 2008, seems to be ending; and the impact of the fiscal stimulus is growing. Other countries, who bore much of the brunt of the inventory liquidation because they provide such a large share of what Americans consume, are already benefiting. Global manufacturing expanded in June for the first time since May 2008, according to a global purchasing-managers index compiled by JPMorgan (see chart).

But caution is still justified. A self-sustaining recovery needs more than just replenishing inventory and government stimulus; it requires a virtuous circle of increasing consumer spending and incomes, and there is still no evidence of that. Sales of cars remain disappointingly meagre. Consumer income is in a vice: not only are jobs and hours shrinking, but hourly pay grew at only an annualised rate of 0.7% during the past three months, the lowest since the data begin in 1964. Jan Hatzius of Goldman Sachs predicts wages will actually start falling next year.


If later this year the recovery still looks likely to remain feeble as the maximum impact of the stimulus is felt, pressure for more stimulus will grow. But it will be harder to deliver than last time. The Federal Reserve cut short-term interest rates in effect to zero in December, then embarked on "quantitative easing" in March by buying bonds with newly printed money. Treasury yields dipped at first, then more than rebounded, because some investors worried that the Fed's radical actions would eventually fuel inflation.

As for fiscal policy, on July 7th Laura Tyson, an adviser to Mr Obama, called for a second stimulus, saying the first is "a bit too small." Mr Obama has demurred, arguing the first needs time to work. Polls also show the deficit is now a bigger priority with voters than more stimulus.

Mr Obama himself has proposed a budget-balancing rule that he would have to break to inject more stimulus—a formality, perhaps, but one that would further erode his fiscal credibility given the gargantuan deficits his policies will produce even beyond 2010. "We could afford to borrow a bit more over the next year if we had a plausible plan to get the deficit under control thereafter," says Len Burman of the Urban Institute, a think-tank. "But nobody has articulated such a plan."

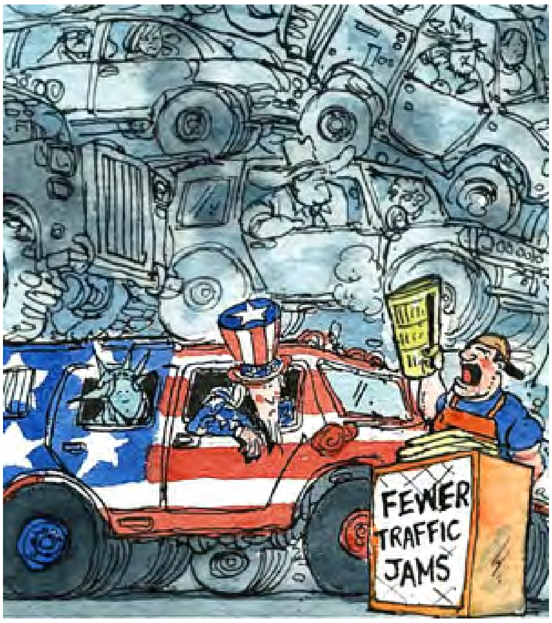
Traffic congestion

# Stalled

Jul 9th 2009 | CHICAGO
From The Economist print edition

**Congestion may be down, but America is stuck**

Illustration by David Simonds




IT SOUNDS like good news. In 2007, for the first time in 16 years, congestion in America's 439 recognised urban areas actually declined. The finding came in a report published on July 8th by the Texas Transportation Institute, which for years has rung an alarm bell from central Texas in the hope that those in Washington, DC, will hear. Politicians usually shake their heads over the institute's findings, but do little else. With the publication of this report, it might seem that fuel prices have solved the problem. Unfortunately they have not.

Even though congestion dropped between 2006 and 2007, it still forced urban Americans to travel for 4.2 billion extra hours and buy an extra 2.8 billion gallons of petrol. The cost of all these delays was $87.2 billion, an increase of more than 50% over 1997. The problem affects metropolitan areas of all sizes, but big ones—the country's economic engines—are in the worst shape. Drivers in Los Angeles suffer the most: in 2007 the average driver spent 70 hours inching along streets and freeways.

Declining congestion can be attributed to two main factors: rising fuel prices and, more recently, a slumping economy—so the figures for 2008 and 2009, when they are compiled, will presumably be a lot better. But neither development is welcome or permanent. History suggests that as the economy rebounds congestion will too, as shipments and commutes resume.

The question, then, is what can be done to help? The stimulus's shovels are ready—last month states met a 120-day deadline for proposing projects—but it is unclear how much the new plans will ease traffic. James Oberstar, a congressman, wants to help big urban areas create plans to mitigate traffic. But his proposal, part of a big reauthorisation for transport, will probably be delayed.

TTI points to simple steps that could help, such as shortening the response time to accidents. In the long term, road pricing is surely the answer. A driver now pays the same petrol-tax-imposed price for roads, whether demand is high or low. Society bears the costs of pollution and wasted time. Road pricing is controversial—a plan to introduce it in Manhattan was scuttled last year. But if Americans don't want to be stuck in their cars, they had better get a move on.

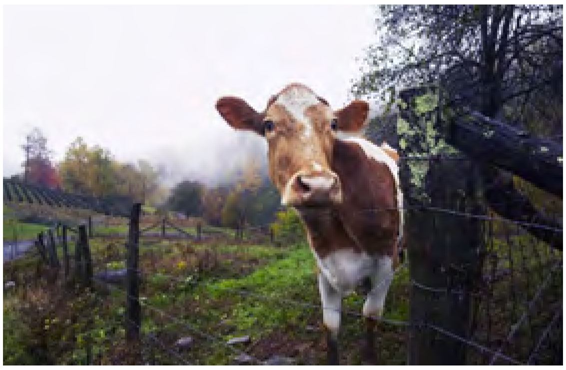
## The crisis in dairy farming

# Milking it

Jul 9th 2009 | STANLEY, WISCONSIN
From The Economist print edition

**Trouble for dairy farmers as global demand shrinks**

Corbis



**Feeling a bit undervalued**

JOE TIRY milks 55 cows in the gentle hills of Wisconsin. His father was a dairy farmer. So was his grandfather. Mr Tiry's farm is small, but he has been trying to modernise. He is building a new milking parlour, with two platforms for cows and a sunken one for himself, so that he can be both efficient and comfortable—his knees ache from years spent squeezing a salary from udders. But despite all his efforts, the farm is struggling. Mr Tiry has seen his ups and downs, but never anything like this.

Since January 2008 milk prices have fallen by nearly half, from $20.50 per hundredweight (45kg) to $11.40 this June as global demand has plummeted and milk intended for export has spilled back onto the domestic market. Farmers are suffering the consequences. The United States Department of Agriculture (USDA) is unrolling programmes to help. The two Pennsylvania senators, Arlen Specter and Bob Casey, have proposed a bill to reform milk pricing. On a more grisly note, the National Milk Producers Federation has just completed a cull of 101,040 cows to reduce supply. But no one knows when prices will rebound. When they do, dairy states such as Wisconsin may look rather different.

The downturn has had the most dramatic effect in Western states, but Wisconsin is not immune. It is home to more dairy farms than any other state and it is famously the only place where "cheesehead" is deemed a compliment. Wisconsin is no longer America's top milk producer—California seized that title in 1993—but the crisis interrupts a slow resurgence. Ten years ago Lee Jensen had a farm of just 115 cows. Now he has more than 900 and a huge automated milking parlour.

The state has nudged Mr Jensen and others forward by providing them with the advice of subsidised consultants. Tax incentives sweeten the deal. Such programmes, combined with support for Wisconsin's dairy processors, seem to have worked. Milk production reversed its decline in 2005. Kathleen Vinehout, a state senator and a former farmer herself, says that the state will continue to have both big farms and small ones, provided the smaller ones find a profitable niche.

Now, however, every type of farm is in trouble. Darla Sikora, of Citizens State Bank of Loyal, Wisconsin, is overwhelmed by requests from farmers. Those faring worst have large debt—a small farm that was scraping by before the downturn, for instance, or a newly expanded farm with too many obligations.

National programmes, presumably, should help. The Milk Income Loss Contract (MILC) programme issues payments to farmers in bad times. A system of marketing orders has helped determine prices since the 1930s. Fixed minimum prices, at which the USDA agrees to buy dairy products, help prop up the market. The merits of these efforts, however, are debated. MILC is expensive and may keep production artificially high. The price support is meagre and awkwardly designed, according to Bob Cropp, an economist at the University of Wisconsin-Madison.

The department, faced with urgent pleas from farmers, expects to spend nearly $1 billion on MILC payments and purchases of dairy products. On July 6th Tom Vilsack, the agriculture secretary (he hails from the corn state of Iowa), even said he might change the old milk pricing systems. Protectionism is rising too. In January the European Union announced it would reinstate subsidies for dairy exports. The USDA has established its own subsidy through June 30th 2010.

As these clunky machinations continue, Mr Jensen follows a simple mantra: “the milk price is going to go up and the milk price is going to go down.” He hedges on the Chicago Mercantile Exchange. Mr Tiry is taking his own measures, lowering his costs by using a new method of grazing. But for many farmers, says Ms Sikora, “every single day, every pound of milk they sell, they’re losing money.” When prices rise at last, the number of farms will have already dropped.

**Health-care reform**

# Pay or play?

Jul 9th 2009 | NEW YORK
From The Economist print edition

**Health reform moves forward, in fits and starts**

Getty Images


**Wal-Mart helps out**

BARACK OBAMA'S plan to overhaul America's health system before year's end faces two problems. One is how to pay for his ambitious goal of universal coverage, and the other is whether to include a government-run insurance plan. There was news on both fronts this week.

The biggest hurdle facing reformers in Congress, to whom Mr Obama has delegated the heavy lifting, is cost; the various schemes on offer all cost at least $1 trillion over a decade. The biggest pool of available cash to pay this bill is the $250 billion tax break provided each year for employer-provided health coverage. In recent weeks, a consensus seemed to be emerging on left and right that some sort of cap on this distorting giveaway was necessary.

But some labour unions, whose members benefit disproportionately from such tax-advantaged health plans, dislike this idea—and now one of their champions is trying to kill it. News surfaced this week that Harry Reid, the Democratic majority leader in the Senate, has scolded Max Baucus, head of the Senate Finance Committee, for trying too hard to woo Republican support. He insisted that Mr Baucus drop any attempt to cap this tax break.

The snag is that without this money it will be difficult to make health reform "budget neutral"—something everyone in Washington, DC, including Mr Obama, claims to want, and without which it will be hard to get a reform bill through the Senate. To make up for the shortfall, Mr Obama persuaded the pharmaceutical lobby to offer $80 billion in "voluntary" price cuts for drugs used by pensioners over the next decade. And this week the hospital lobby said it could cut the rates it charges the government by over $150 billion over 10 years.

This is still not enough money, so momentum is growing on the left to impose "pay or play" on employers: firms must either provide decent health cover, or pay a fine. Though such a mandate invokes populist notions of shared responsibility, most economists think it a bad idea because it will hit firms employing poorly skilled workers the hardest. Len Nichols of the New America Foundation, an influential think-tank, argues that while an individual mandate requiring people to purchase insurance is a good idea, the employer mandate is not: pay or play is, he insists, "essentially a tax on low-wage labour".

Perhaps predictably, business hates the idea. So it came as a shock when Wal-Mart, the world's biggest retailer and the *bête noire* of the political left, sent a letter to the White House on June 30th supporting an employer mandate (if accompanied by cost-control measures). Cynics pointed out that Wal-Mart pays more for employee health cover than weaker or stingier rivals, so any such mandate would raise costs for its competition. Even so, this once-moribund idea suddenly has political legs.

Aside from cost, the other great health debate this year involves whether to include a public insurance plan to compete against private insurers. This week, Mr Reid made clear his desire for a strong public plan—something that the insurance lobby has vowed to fight to the death. On this front too, a messy bit of good news surfaced this week. Rahm Emanuel, Mr Obama's chief of staff, softened the president's previous insistence on such a plan by floating a compromise. He suggested that a public plan should come into force only if an initial attempt to reform private insurance markets fails.

Cyber-bullying and the courts

# Megan's law

Jul 9th 2009
From The Economist print edition

**A sad case in Missouri prompts national concern**

MEGAN MEIER was a troubled 13-year-old girl in the small St Louis suburb of Dardenne Prairie. In 2006 one of the few bright spots in her life was her online boyfriend with the soap opera-ish name Josh Evans. She was happy until Josh suddenly turned on her, writing "You are a bad person and everybody hates you…the world would be a better place without you." Megan hanged herself in her bedroom wardrobe.

Four houses down the street Lori Drew reportedly laughed when she heard of the suicide. She was masquerading online as the teenage boy to see if Megan was saying anything bad about her own daughter Sarah. When exposed by a local newspaper Ms Drew became one of the most hated women in America and the centre of a legal controversy.

The county prosecutor discovered there was no law on the books to make a case against Ms Drew, though the state of Missouri quickly passed laws on cyber-bullying for the future. The federal government filed charges against Ms Drew in Los Angeles, where MySpace is based, on the theory that she committed fraud in violation of the terms of service and engaged in a criminal conspiracy.

Last November a jury failed to reach a verdict on the conspiracy charge but convicted Ms Drew of three lesser charges of misuse of the terms of service to injure another. The federal prosecutor petitioned the judge to sentence her to three years in prison and a $300,000 fine. But at the sentencing, on July 2nd, the judge set aside the verdicts on the theory that violations of the terms of service are so common that holding one person criminally liable would subject too many others to prosecution.

The decision is not final until the judge produces it in writing and, bizarrely, he indicated from the bench that he might yet change his mind. The prosecutor is waiting for the written decision before considering a further appeal.

As for Ms Drew, upon learning of her good fortune, she said that she should never have been charged in the first place. Yet she and her family have been forced to move out of Missouri—in part because of cyber-attacks. Many people think that the law has not kept up with technology in this area. So the Megan Meier Cyberbullying Prevention Act is now pending in Congress. But it will be too late for a sad young girl.

Statewatch: Florida

# Sorrow in the sunshine

Jul 9th 2009 | CRYSTAL RIVER
From The Economist print edition

**Sun, sand and seniors are not enough. Florida needs to diversify**

Eyevine

SAILORS of old sometimes mistook manatees for mermaids, which shows how months at sea quaffing rum and missing female company can cloud one's vision. Manatees (also called sea-cows) actually look like giant underwater slugs. Yet tourists love being kissed by them. A friendly manatee may swim right up and touch your face with his. Some people find this spiritually uplifting. Others merely think it fun to touch something so bulbous and endangered.

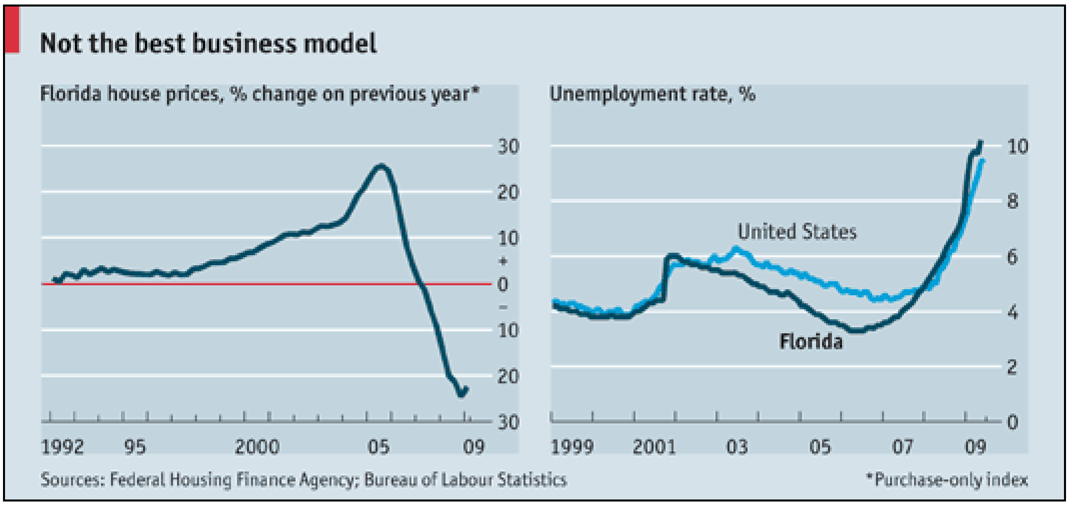
Either way, Crystal River, home of perhaps the world's largest herd of wild manatees, has long profited from hordes of holidaymakers flying thousands of miles to swim with them. But not this year, alas. "It's the holiday weekend and the boat is half-empty," grumbled Mike Birns, a guide for Sunshine River Tours, a small local operation, on the Thursday before July 4th.

Florida is reeling. Despite its many attractions, from riding the rollercoasters at Disney World to riding with the Bare Buns Bikers (a group of nude motorcycling enthusiasts), tourist arrivals in the first quarter fell by 10.6% from last year. In a global recession, dream vacations get deferred. Visitors are coming from closer by and spending less when they arrive.

Meanwhile, Florida's property bubble has popped violently. Empty condos blight the eastern seaboard. The median price of a home in Cape Coral-Fort Myers has fallen by two-thirds since 2006. Statewide unemployment, at 10.2%, has trebled since then, as bricklayers lay down their hods and tour guides doff their Mickey masks.

Florida's recession began earlier than the national one. Mark Wilson, the head of the Florida Chamber of Commerce, recalls sitting in an airport in 2007 reading an article in the *Wall Street Journal* headlined: "Is Florida Over?" It argued that Florida could no longer rely on migration to drive its economic growth. Mr Wilson agrees. "The Florida we've known for 30 years is gone," he says.

Florida's population has risen tenfold since the 1940s, to 18.3m. People visit, love the weather and stay. Native Floridians sell them houses, fix their teeth and pan-sear their scallops. The state even milks newcomers by charging them steeper property taxes. But when the influx slows—and Ohioans are finding it rather difficult to sell their houses just now—the Sunshine State's economy sputters.




Businesses are struggling to survive. Many, such as Sunshine River Tours, have cut their prices. Others are getting creative. The Sea School for merchant sailors in St Petersburg, for example, has boosted enrolment by offering a course in how to handle Somali pirates. Mr Wilson thinks Florida needs to shift from an economy based on tourism, construction and agriculture to one with more better-paid high-tech jobs. As a positive sign, he cites the opening of laboratories in Florida by three non-profit research organisations—though all three were lured with subsidies.

The dream of a high-tech Florida is not outlandish. NASA, which was due to launch another Space Shuttle this week, attracts rocket scientists. Florida's many retirees create a demand for hospitals, around which biomedical researchers cluster. The sun and fun that lure tourists also help high-tech firms woo talent, says Phil Holt of EA Tiburon, a video-game developer near Orlando. But other states have balmy weather, too. And Florida's education system leaves much to be desired, though an overhaul is in progress.

Florida's state government is business-friendly, but not uniformly so. Not much oil-drilling is allowed offshore. A referendum in 2010, dubbed the "Vote on Everything" initiative, would require popular votes on changes to local land-use plans. Businesses fret that this will lead to thousands of local referenda each year and make it dauntingly tough for anyone to build a new office, factory or theme park.

Another looming threat concerns the weather. Some of the nicest homes in Florida are periodically crushed by hurricanes. Two years ago, after homeowners complained about rising insurance premiums, the governor, Charlie Crist, leaned on firms to cut prices and offered Floridians state-subsidised policies. Private insurers curtailed their operations or pulled out. When the next hurricane hits, the repair bill will land squarely on Floridian taxpayers, rather than being spread among global insurers. It would be hard to devise a surer formula for economic catastrophe.

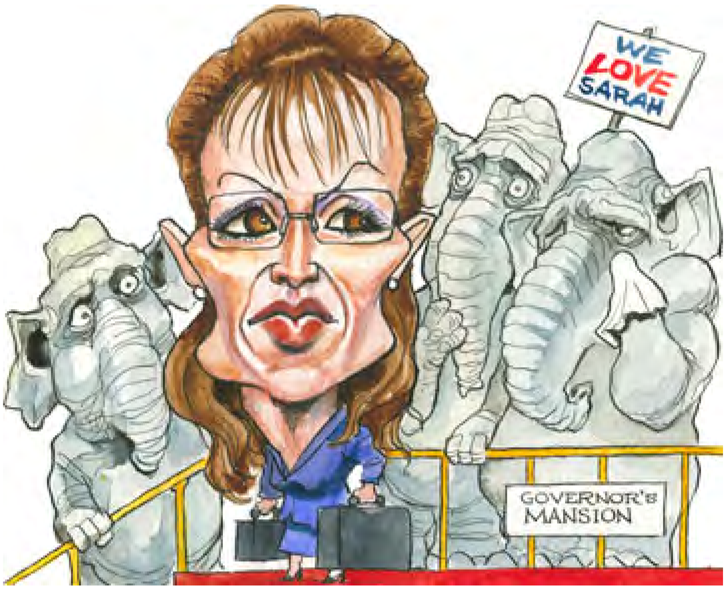
Lexington

# The passing of Palin

Jul 9th 2009
From The Economist print edition

**Sarah Palin will never be president. But her resignation leaves a gap in American politics**

Illustration by KAL




ON A trip to Alaska three years ago, Lexington watched a former small-town mayor perform in a Republican primary debate. One of her rivals was the sitting governor, a man of far greater political experience. She trounced him. Granted, he was so dull that even his campaign song admitted it. Still, it was an arresting performance.

Strange to recall, when John McCain picked Sarah Palin as his running-mate last year, almost no one had heard of her. Now she is the most divisive figure in America. To mention her name at a dinner party in the highly educated liberal suburb where Lexington lives is to ask for trouble. “Moron”, “idiot” and “megalomaniac” are some of the gentler epithets that will be used. Some will admit to hating her. Many will guffaw at her trashy family. Yet half the country loves her.

A Pew poll last month found that Americans’ opinions of Mrs Palin were evenly balanced. A hefty 44% took a dim view of her, while 45% took a rosy one. Among Republicans, she scored a whopping 73% approval rating, far outpacing any other plausible contender for the party’s presidential nomination in 2012. Of course, that poll was taken before she announced, on July 3rd, that she would step down as governor of Alaska without finishing her term. This bombshell was unexpected, and makes it highly unlikely that she will ever be president. Asked what they seek in a commander-in-chief, few Americans cite a tendency to cut and run when the going gets tough.

Mrs Palin may know this. She may have decided that the hazing of a presidential campaign is simply not worth the uncertain reward. Her resignation speech was rambling and often incoherent, but she made it clear that she has not had much fun of late. Before she was thrust under the national spotlight, she was an extremely popular governor who got on well with Democrats and worked with them on practical projects such as a gas pipeline. Now, she complains, the Democrats in Alaska won’t work with her any more. “Political operatives” have descended on the state to dig up dirt and file ethics complaints against her. This has saddled her with half a million dollars in legal bills and made her job impossible. She also mentioned not liking some of the press coverage she and her family have endured.

To half the country, this sounds like pathetic whining. Politics is a tough business. If you can’t cope with harsh criticism, perhaps you should find a less demanding line of work, such as making lucrative

speeches to friendly audiences. To the other half of the country, however, Mrs Palin's complaints ring true. And the divide is largely a cultural one. Many liberal or well-educated Americans feel it their patriotic duty to point out that the Caribou Barbie is far too ignorant to be allowed anywhere near the White House. But many rural and working-class whites adore her, and resent the way she has been ridiculed.

This divide matters. Many Americans want as president someone who is exceptionally well-informed about public policy, who surrounds himself with experts, who weighs the evidence and then does what is best for the country. But few people are policy experts, so they often follow their hearts rather than their heads when deciding whom to vote for. Often, they assume that someone culturally similar to themselves will be more likely to look out for their interests. And that is why Mrs Palin is still so popular. There are an awful lot of Americans who see her as one of their own. She talks like them. She guts her own fish. She wears her faith on her sleeve. She obviously didn't go to Harvard. And when people who did call her stupid or mock her faith or her family, her fans take it personally.

The kind of people who support Mrs Palin have several grievances. They are less well-educated than the American average, so the labour market has been unkind to them for years. They are often white and male, but they do not feel privileged and they often chafe at the way affirmative-action policies discriminate against them. In short, they are the Republican Party's base. There are not enough of them to decide a general election, but more than enough to decide a primary. And that leaves the Republicans in a bind. Party bigwigs do not want Mrs Palin to be their nominee, not least because they think she would be sure to lose to Barack Obama. They hope that her resignation has opened a space for a less polarising and more competent candidate.

## Rudderless Republicans

But who? Mark Sanford, the governor of South Carolina and a prominent fiscal conservative, disqualified himself last month by giving a news conference to explain how much he loved his mistress. Tim Pawlenty, the governor of Minnesota, is young, moderate and evangelical but has yet to set national pulses racing. Mitt Romney, a former governor of Massachusetts, is doing well in the polls. As a successful businessman and the architect of his state's universal health-insurance system, he passes the competence test. But he lacks the common touch. Jon Huntsman, a former governor of Utah and soon-to-be ambassador to China, is impressive but little known. Mike Huckabee, a former governor of Arkansas and Baptist preacher, is charismatic but too preachy for some. None of these candidates has Mrs Palin's star power.

The primaries are nearly three years away, so much could change. If the economy recovers, Mr Obama will be hard to beat. But if unemployment stays high and the debt looks terrible he is in trouble. The same goes for the Democrats in Congress. Their majorities are so large that the Republicans will probably fail to recapture either the House or the Senate in 2010. But they could well make gains. The key test will be whether the party can find a leader who will enthuse its Palin wing without pandering to it. And that will be harder than a frozen moose. You betcha.

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Economist.com/blogs/lexington

**After Mexico's mid-term election**

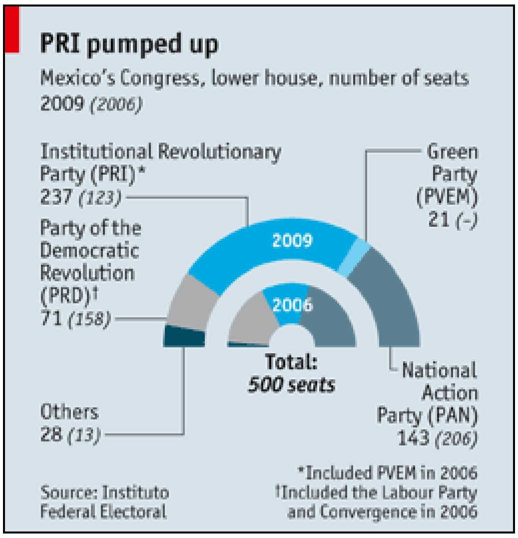
# Calderón's hatful of troubles

Jul 9th 2009 | MEXICO CITY
From The Economist print edition

**The PRI's victory means that change in Mexico now depends more on the former ruling party than on the president**

Illustration by Peter Schrank


"WE WON just about everything," said Beatriz Paredes, the president of the Institutional Revolutionary Party (PRI), in an accurate summing-up of the mid-term election on July 5th. Not only did the PRI, which ruled Mexico for seven decades until 2000, more than double its seats in the lower house of Congress. It also won five of the six state governorships in play and many important mayoralties. Although it won only 37% of the vote (on a turnout of 45%), the PRI will now take most of the decisions that matter over the next three years.




That is bad news for President Felipe Calderón, whose conservative National Action Party lost badly (see chart). Mr Calderón remains personally popular. He campaigned on his crusade against organised crime. Polls suggest that most Mexicans back this (though less enthusiastically than they did). But they worry more about the slumping economy. And although the president tarred the PRI as corrupt, at least some voters seemed persuaded by the PRI's slogan of "proven experience, new attitude". The party, which spans the amorphous centre ground of Mexican politics, may also have been helped by the disarray of the left, which is split between supporters and opponents of Andrés Manuel López Obrador, the man defeated by Mr Calderón in 2006.

The president looked shaken by the scale of his party's defeat. His job has not been easy. He took office in 2006 with a precarious mandate: perhaps a quarter of Mexicans still follow Mr López Obrador in refusing to accept his victory. He chose to tackle organised crime which was largely unchecked under his predecessors. The economy shrank by 5.9% in the first quarter alone, the worst performance in the Americas. Both unemployment and underemployment have nearly doubled, leaving one Mexican in six looking for a job. Poverty has risen.

The slump may turn out to be worse than that of 1995, which followed a bungled devaluation and which

did much to break the PRI's long hold on power. Mr Calderón argues, accurately enough, that this time the recession was caused not by government mistakes but by slumping exports to the United States (as well as a fall in remittances and tourists from there). But his claims that the worst was over seemed over-optimistic. Stimulus measures, which have included increased spending on anti-poverty and make-work programmes as well as interest-rate cuts, have been overwhelmed.

Recession has laid bare the economy's longstanding structural weaknesses. Monopolies or oligopolies, in industries ranging from telecommunications to cement, trim the long-term growth rate by 1% a year, according to Guillermo Ortiz, the governor of the central bank. Energy remains almost entirely in state hands. Oil production is falling by up to 10% a year, and proven reserves are now equal to just 13 years of current output. Thanks partly to the stranglehold exercised by the teachers' union, Mexico's educational performance is poorer than it should be given its income level. Federal tax revenues are just 9% of GDP; public spending on infrastructure is declining. Mexico sank to 60th place (from 52nd last year) in the league table of competitiveness published by the World Economic Forum, a Swiss-based organisation.

Mr Calderón has tried to tackle some of these problems. But a tax reform was largely nullified by the courts. An energy reform was heavily watered down to appease Mr López Obrador and other opponents of private investment. An education reform was crimped by Mr Calderon's alliance with the head of the teachers' union. The government has also been hampered by Mr Calderón's tendency to pick his aides for their loyalty rather than their talent.

Officials insist they are making progress. They are inviting bids for a new fibre-optic network which they hope will smash the near-monopoly of fixed-line telephone service held by Telmex, whose main owner is Carlos Slim, the world's second-richest man.

They also insist that reforms of the legal framework governing policing and the courts will soon have an impact in the battle against organised crime (thus boosting investor confidence). They claim as victories the rising numbers of traffickers arrested or killed, and seizures of drugs, weapons and cash. But violence has not abated: in the first six months of this year there were 3,247 drug-related killings, compared with 1,935 in the same period of 2008, according to press reports. The government's continued reliance on the army for police duties has seen a predictable rise in allegations of abuse. The authorities' goal of turning organised crime into a policing problem, rather than a threat to national security, remains a distant one.

Some progress, especially in policing, can come through better administration. But shaking up the economy and plugging the yawning chasm in the public finances requires legislation. Many economists argue that now that the election is out of the way, the government should seek an early tax reform and another energy reform.

The political system, marked by paralysis and corruption, needs attention, too. Such is the disillusion that almost 5.4% of those who voted spoiled their ballots, heeding a campaign by a network of middle-class activists. Many constitutional provisions were designed for one-party rule and need changing. Allowing legislators to stand for consecutive terms would increase their accountability, for example.

All of these initiatives mean taking on powerful vested interests. Whether that happens now depends more on the PRI than Mr Calderón. Its alliance with the Green Party (a misnomer for an opportunist law-and-order outfit) will give the PRI a majority in the lower house. In the outgoing Congress it diluted the president's reforms. Will that now change?

The answer depends in part on the uncertain balance of power within the PRI. Ms Paredes is a modernising social democrat. She shares the spotlight with Enrique Peña Nieto, the telegenic governor of the populous state of Mexico who has links to the party's most reactionary wing. In the shadows is Manlio Fabio Beltrones, a wily senator. It helps that Ms Paredes has a good personal relationship with Mr Calderón.

Awkwardly, the PRI is pledged not to widen VAT or support re-election for legislators. Some PRI politicians privately favour a return to accommodations with drug traffickers, and would be happy with a corporatist economy. But most voters would not. It may take the stewards of the old order to usher in a new one.

**Post-coup Honduras**

# Enter the diplomats

Jul 9th 2009 | MEXICO CITY
From The Economist print edition

**Can negotiations reinstate Manuel Zelaya?**

AP

Zelaya: so near yet so far

WHEN a coup toppled Hugo Chávez from Venezuela's presidency in 2002, it took just three days for him to return to office. Manuel Zelaya, an ally of Mr Chávez who was ousted as Honduras's president by a military coup on June 28th, has had no such luck. Emboldened by universal condemnation of the coup and calls for his reinstatement, Mr Zelaya rashly tried to return to his country even though its new rulers vowed to arrest him if he did. After his gambit failed, his future now depends on an attempt at mediation by Óscar Arias, the president of Costa Rica.

Equipped with a plane and a journalistic entourage by Mr Chávez, on July 5th Mr Zelaya flew over Tegucigalpa airport but was prevented from landing because the army had blocked the runway. At least 10,000 people had answered his call to greet his hoped-for triumphal return. They tore down part of the fence surrounding the airport, and pelted the soldiers surrounding it with stones. The troops responded with rubber bullets and tear gas, and some appeared to have opened fire. One protester died of a gunshot wound, and dozens were injured.

Mr Zelaya's journey was backed by Latin America's more radical leftist governments. Presidents Rafael Correa, of Ecuador, and Cristina Fernández, of Argentina, accompanied him to Central America in a second plane, together with José Miguel Insulza, the secretary general of the Organisation of American States (OAS). They ignored a plea from the leader of Honduras's Catholic church, Cardinal Óscar Andrés Rodríguez, who warned that the venture might lead to bloodshed.

The de facto government, led by Roberto Micheletti, has the backing of Honduras's Congress, its courts, the army and much of the population. They insist that Mr Zelaya violated the constitution by trying to convoke a constituent assembly which they fear might have prolonged his term. Their defiance led to a unanimous vote to suspend Honduras from membership of the OAS, since the coup violated its Democratic Charter.

His return thwarted, Mr Zelaya met Hillary Clinton, America's secretary of state, and agreed to mediation by Mr Arias, who won a Nobel prize for his peacemaking efforts in Central America in the 1980s. Mr Zelaya was due to meet Mr Micheletti in Costa Rica on July 9th.

Mr Zelaya insists he should serve out his term until January. Mr Micheletti is equally firm in saying that he will not turn over the presidency. Yet a deal, involving some sort of co-government and bringing forward a presidential election due in November, as Mr Micheletti has offered, may yet be possible.

The longer the stalemate lasts the uglier things may get. Mr Micheletti's regime has imposed a curfew, suspended some constitutional freedoms and shut down media that favoured Mr Zelaya. But the events at the airport apart, so far there are no confirmed accounts of attacks on civilians, and those arrested have been quickly released, according to Human Rights Watch, a campaign group. The army has allowed peaceful demonstrations to proceed.

Much will now turn on whether Mr Zelaya's supporters, who include trade unions, teachers and leftist social movements, are able to step up disruption. The teachers have begun a strike. Some protests have turned violent. Policing disruptive protests without bloodshed will be a test for the army.

The second crucial factor will be whether or not the de facto government faces effective sanctions. Mr Chávez has halted shipments of cheap oil. The World Bank and the Inter-American Development Bank have “paused” loans. The United States has suspended most of its aid. But Honduras’s Central American neighbours may be reluctant to disrupt their own economies by blocking trade.

It was easy for Latin Americans and others to condemn the coup. The harder part was always going to be achieving Mr Zelaya’s reinstatement. Bluster and confrontation have failed. If Mr Arias’s American-backed mission to mediate succeeds, Barack Obama’s administration may yet emerge from its first big test in Latin America with its prestige enhanced.

**Brazil's scandal-plagued Senate**

# House of horrors

Jul 9th 2009 | SÃO PAULO
From The Economist print edition

**What Britain's MPs might learn from Brazilian Senators**

THE president of Brazil's Senate sits in a fine blue leather chair designed by Oscar Niemeyer, a celebrated Brazilian architect. Comfortable it may be, but its occupants have also found it to be an insecure perch. Three senate presidents have been suspended or have resigned because of scandals in the past eight years. Now a fourth, José Sarney, a former president of Brazil and part-time novelist, is teetering.

The Senate has just 81 members but somehow they require almost 10,000 staff to take care of them. Many of these are appointed as favours to senators' friends or political supporters. One former staffer says that his fellow-employees used to say that the senate was like a mother to them. Others liken it to a country club. The benefits of membership include free health insurance for life for all senators and their families, generous pension arrangements and housing allowances. This much was already familiar to Brazilians and, perhaps, not so different from the goings on in many other legislatures around the world.

But the past few months have brought new revelations. The police are investigating some 660 "secret acts" passed since 1995 which have awarded jobs and pay rises to members of staff. Senators have given free air tickets to relatives and claimed housing allowances for houses they did not live in. Senate staff were paid overtime even when the chamber was in recess. The head of the senate administration, Agaciel Maia, was revealed to own a house worth 5m reais ($2.5m) that was registered in his brother's name and thus not declared to the tax authorities.

Lots of senators, more or less across the political spectrum, are at fault. When the leader of the opposition Party of Brazilian Social Democracy went on a jaunt to Paris, for example, the Senate paid his hotel bill. (He says this was a "loan".) It therefore might seem unfair that Mr Sarney is under pressure to resign.

Yet he cannot plead ignorance of the Senate's workings. This is his third spell as its president. During a previous stint in the blue chair he appointed Mr Maia to his lucrative position. A grandchild of Mr Sarney's received business from the Senate (although he was not its president at the time). Mr Sarney also omitted from his declaration of assets to the federal electoral tribunal a big house he owns in Brasília.

Mr Sarney, who has spent 50 years in public life, is a survivor. He will probably keep his post. He remains a power in the Party of the Brazilian Democratic Movement (PMDB), a catch-all outfit that is an important part of President Luiz Inácio Lula da Silva's governing coalition. Lula wants Mr Sarney to swing the weight of the PMDB, and its patronage machine, behind Dilma Rousseff, the probable candidate of the ruling Workers' Party in the presidential election next year.

Lula has said that Mr Sarney deserves more respect, and has blamed the press for whipping up scandal. But at a time when the economy is only just emerging from recession, the saga of the "secret acts" has reminded Brazilians that their politicians never impose austerity on themselves. It may also have reminded them of the flaws of some of Lula's allies, and his willingness to shut his eyes to scandal when it suits him.

**Swine flu in Argentina**

# Pigheaded policies

Jul 9th 2009 | BUENOS AIRES
From The Economist print edition

**The dangers of a reputation for dodgy statistics**

AP

IT IS winter in South America's southern cone, so it is no surprise that swine flu is rampant. But its impact is not uniform. It came first to Chile before it turned up across the Andes in Argentina. But in Argentina 2.4% of reported cases have resulted in the death of the patient while in Chile the corresponding figure is just 0.2%. Why?

Part of the answer seems to lie with the way that health services are organised. In Argentina health policies as well as health budgets are in the hands of provincial governments. That is a contrast not just with Chile's centralised system but also with Brazil, which like Argentina is a federal country, but where the health ministry in Brasília sets overall national goals.

This means that when a bug strikes Argentina it is met by a health system whose officials talk to each other infrequently, have different objectives, and dip into pots of cash of widely varying size. For example, Santa Cruz, an oil-rich province in Patagonia, spends eight times more per head on health care than Corrientes, in the poor north-east, according to Daniel Maceira, a health economist. On July 6th several of the needier provincial health ministers were promised a bit more federal help to fight the flu.

A second factor that may have made things worse in Argentina is that the government may have been slow to respond. Some doctors accuse it of deliberately downplaying the outbreak until after a mid-term election on June 28th. The health minister resigned because her request to delay the election was denied (though she waited until after the vote to go). An advisory committee of medical experts assembled by the government has called for a national health emergency to be declared, but that has not yet happened.

The accusation of time-wasting may in fact be unfair. But Argentines have come to mistrust the authorities. Under Cristina Fernández, the president, and her predecessor and husband, Néstor Kirchner, they have become accustomed to the government fiddling economic statistics, such as inflation and growth rates.

Rightly or wrongly, many seem to believe that officials have understated the number of people who have gone down with flu (which might be an alternative explanation for the seemingly high death rate). This week panicked Argentines travelled to Chile and Uruguay in droves to buy drugs such as Tamiflu, despite the government's insistence that it would ensure there are sufficient stocks.

Chile's response seems to have been swifter, better co-ordinated and more decisive. On the same day that the World Health Organisation raised the alert about swine flu back in April, Michelle Bachelet, Chile's president, gathered a committee of experts to discuss the threat. It may have helped that Ms Bachelet is a medical doctor by profession.

Argentina's halting reaction could affect the economy. Miguel Kiguel, a consultant, reckons that swine flu could shave 0.5% off GDP between July and the start of spring, in September. Theatres have closed down for ten days, the first time they have all gone dark since 1918 when Spanish flu swept the world. Brazil's government has urged its citizens not to visit Argentina. Flights from Brazil to Bariloche, a Patagonian ski resort, have been cancelled. Unluckily for the town's winter sports, swine flu is expected to die down only when the snow melts.

The war in Afghanistan

# Into Taliban country

Jul 9th 2009 | LASHKAR GAH
From The Economist print edition

**America’s “surge” in Afghanistan begins—and allied tactics change**

AP

UNDER cover of night, driving through the desert or landing from helicopters, America’s marines went “big, strong, fast” into the Taliban’s strongholds in Helmand province. More than 4,000 marines and about 650 Afghan soldiers reached their targets in just seven hours.

Operation Khanjar (Thrust of the Sword), which began on July 2nd, was the biggest action by the marines since they retook the Iraqi city of Fallujah in 2004. But unlike their comrades in that bloody urban battle, the marines now in Afghanistan have, for the most part, thrust their swords into hot air. With the Taliban melting away in many places, the marines’ biggest enemy has often been the heat—“hot as fire”, says their commander, Brigadier-General Larry Nicholson. Some complained they had not been able to fire enough rounds to lighten their heavy packs.

But General Nicholson, for one, was not disappointed. His object was not to kill Taliban soldiers but to protect the population. Each company commander was told his first task should be to organise a council, or *shura*, with local elders to deliver the message that the marines had come to stay and to extend the writ of the central government in Kabul. A parallel operation, Panchai Palang (Panther’s Claw), has been a gritty and bloody affair in which British forces have been slugging it out with the Taliban for control of the district of Nad Ali. The British have lost seven soldiers, including a battalion commander in the Welsh Guards, Lieutenant-Colonel Rupert Thorneloe, this month alone.

The operations have two main aims: to enlarge and merge the patches of territory controlled by NATO along the “green zone” (the ribbon of irrigated land alongside the Helmand river and its tributaries) and to interdict the flow of Taliban fighters and weapons through the desert from Pakistan. The marines are pushing into insurgent-held areas in the districts of Nawa and Garmser (see map). They have also struck deep in the south to build a new base in the town of Khanishin, from where marines will try to disrupt Taliban supply routes. On July 8th the Afghan flag was raised over the town’s 18th-century fort.

General Stanley McChrystal, the overall American commander, said his force may soon assault Marja, a well defended stronghold of the Taliban and drug smugglers. The Taliban said their own response, Operation Foladi Jal (Iron Net), would avoid frontal battles but would teach the marines “a lesson” through roadside bombs and ambushes.

Thrust of the Sword is the first big move since President Barack Obama’s decision to shift forces from Iraq to Afghanistan. Oddly, perhaps, the assault is taking place before the marines are at full strength in Helmand, and before the recently appointed

General McChrystal has completed his review of operations.

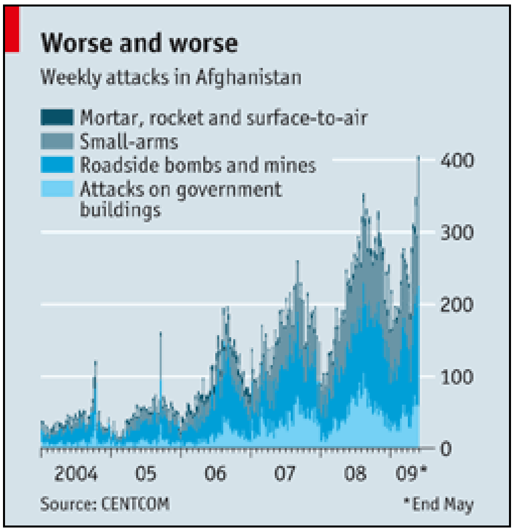

Theorists of counter-insurgency say that fighting guerrillas requires time and patience (and even more foreign and local soldiers than are available in Afghanistan). But General McChrystal is a man in a hurry. He needs to enable as many people as possible to vote in Afghanistan's presidential election next month, and he needs to show he is turning the tide of war before America's mid-term elections next year. So at the moment, he is using the plan devised by his abruptly sacked predecessor, General David McKiernan, who was criticised in the Pentagon for being, among other things, too cautious and unimaginative.

The biggest change under General McChrystal is the instruction to reduce civilian casualties. A "tactical directive", issued at the start of Thrust of the Sword, says that winning the support of the Afghans overrides all else. "We must avoid the trap of winning tactical victories—but suffering strategic defeats—by causing civilian casualties or excessive damage and thus alienating the people," he says. This may increase the danger to troops; but the greater risk is to push Afghans into the arms of the Taliban.

A classified passage sets out how air strikes will be curtailed. But on the ground, his officials say, the share of firefights involving close air support has already fallen from 35% to 17% in the past month. During the summer of 2007 an average of 22 tonnes of ordnance was dropped on Helmand every month.

Since 2006 Helmand has been the responsibility of an underpowered British force, now numbering about 8,000 soldiers, with even smaller contribution from Denmark, Estonia and others. It has become one of the most treacherous parts of Afghanistan, producing more than half of the world's opium poppies. By July 7th 176 British soldiers had died in Afghanistan, roughly the same number as were killed in Iraq (America has lost 726 soldiers in Afghanistan, and 4,321 in Iraq).

The arrival of the first American reinforcements in Helmand last year, in the form of a 2,400-strong marine expeditionary unit, did not achieve much. This year the Americans are deploying a full marine brigade, some 10,000 men in all, plus a combat aviation brigade from the 82nd airborne division, to try to get a grip.




**Worse and worse**

Weekly attacks in Afghanistan

Source: CENTCOM *End May

Much damage has already been done by inconclusive operations. British forces often fought their way into insurgent areas, only to withdraw and let the Taliban return, exposing residents to retribution. British commanders now think this was worse than leaving the Taliban in control. "Before the British came, everyone was happy they were coming to bring security and reconstruction," says Haji Mahboob Khan, a senator from Garmser district. "But all the British brought was chaos."

Nad Ali illustrates much of what has gone wrong. The district had been one of the few loyal to the government. But the Afghan police there, as elsewhere, are corrupt, often predatory and driven by local tribal interests. The force is dominated by the Noorzai tribe which controls the lucrative drugs trade. Attempts to reform the force by giving it a crash course in policing and installing Western mentors have produced few improvements. Worse, the eradication of poppy fields in Nad Ali pushed the population into supporting the Taliban. Such errors explain why America wants to change the focus of counter-narcotics from eradication of farmers' fields to targeting middlemen.

General Nicholson says NATO will change its ways: "Where we go, we will stay; and where we stay we will hold, build and work toward transition of all security responsibilities to Afghan forces." The problem for the marines, as for other NATO forces, is that there are nowhere near enough Afghans. Thrust of the Sword involved just 650 Afghan soldiers alongside 4,000 marines. General Nicholson wants as many Afghans as Americans.

Moreover, America needs not just Afghan soldiers but Afghan government—and Afghanistan has little in the way of working government institutions. Without them, the marines are operating in a vacuum. "The

Helmand people just want peace; not reconstruction even, just peace," says Haji Mahboob Khan. "But if NATO sent another 100,000 troops to Helmand, without a good government that is free of all these thieves, they won't be able to bring security."

Economist.com WORLD ASIA

India's budget

# Hopes suspended

Jul 9th 2009 | DELHI
From The Economist print edition

**The re-elected government's first budget falls short of expectations**

FROM the ramparts of Bandra fort, built by the Portuguese and now haunted by bashful couples, you can admire Mumbai's new "sealink", a suspension bridge linking the city's suburbs with its downtown neighbourhoods, almost 3 miles (4.7 kilometres) away. Opened on June 30th, after much delay and dispute, this addition to India's infrastructure should relieve Mumbai's notorious congestion.

Investors had analogous hopes for India's budget, unveiled six days later by the finance minister, Pranab Mukherjee. After the Congress party's decisive re-election in May, investors hoped the budget would start clearing the tailback of delayed reforms the government had been unable to pass in its first term, when it relied on the support of India's communist parties.

Those hopes helped lift the Bombay Stock Exchange by over 20% from the election result to the eve of the budget. They were buoyed by the finance ministry's own Economic Survey, published a few days beforehand by its economic advisers. The survey presented a bold wish-list of reforms, including raising at least 250 billion rupees ($5 billion) a year by selling minority stakes in government enterprises (so-called "disinvestment"), easing restrictions on foreign direct investment (FDI); and even tinkering with the labour laws. Little of that, however, made it into Mr Mukherjee's speech. No FDI caps were lifted, not even in insurance, which is under the finance ministry's purview. And the finance minister budgeted only 11 billion rupees from disinvestment. By the end of the day, the stockmarket had fallen by almost 6%.

Of most concern to investors, perhaps, was Mr Mukherjee's admission that the central government's deficit would widen to 6.8% of GDP in the year to March 2010. It now borrows 34 out of every 100 rupees it spends. Add the red ink of India's state governments and various borrowings reported "below-the-line", and India's deficit could reach about 12% of GDP, according to Standard & Poor's (S&P). The rating agency reminded investors that India was in danger of losing its investment grade.

The government's insouciance is perhaps understandable. It did nothing the economic liberals wanted in the past five years and still won re-election with an increased majority. The financial crisis has hardly strengthened the liberals' hand in the government. For Mr Mukherjee, the crisis only proves that Indira Gandhi's decision to nationalise the banking system 40 years ago was "wise and visionary".

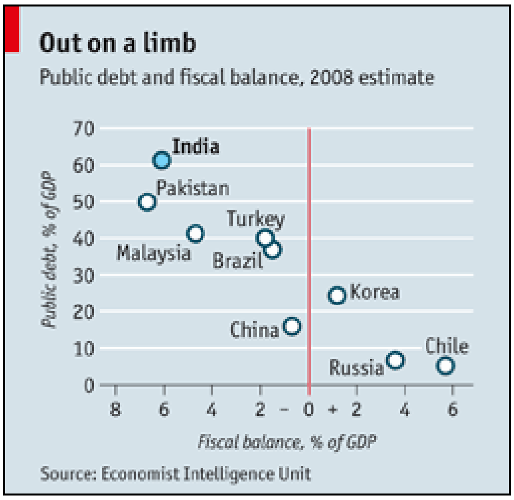
Moreover, India has weathered the global recession better than most. Its GDP grew by 5.8% in the last quarter of 2008, compared with the year before, and by the same amount in the first quarter of 2009. Almost 80% of that growth came from extra government spending, says CRISIL, an Indian rating agency. The government is not yet ready to tighten the purse-strings.

Mr Mukherjee admits he is taking a "calculated risk" with the public finances. And the odds are worse than they should have been. India had a precious opportunity to turn its finances around during the boom years—and let the chance slip. Despite strong growth and low interest rates, its public debt was still over 80% of GDP on the eve of the global crisis, worse than India's peers (see chart). Now it is back to 85%, says S&P.

As the economy recovers, tax revenues will revive. Generous backpay for civil servants and a loan write-off for small farmers will hurt the budget this year but do little damage next. Spending on the government's rural workfare scheme, which will increase by 30% this fiscal year, should also fall when the labour market tightens.

But not all of the fiscal lesions will heal themselves. Last year, according to the IMF, the government spent about as much on misdirected subsidies of fuel, fertiliser and food (3.7% of GDP) as

on education and health. In his speech, Mr Mukherjee proposed some useful changes to fertiliser subsidies but merely postponed discussion of fuel subsidies which wreak fiscal havoc whenever oil prices rise.




## Fruitful Kautilya

If the government's proposed spending reforms were lacklustre, its tax reforms were more promising. Quoting Kautilya, an ancient authority on statecraft, Mr Mukherjee promised not to "collect unripe fruits". He still hopes to introduce a nationwide goods and services tax (GST) by April 2010. This would replace India's service tax, as well as the value-added taxes levied by the central and state governments. With luck, it will also replace the myriad other duties and surcharges that pluck the fruits of Indian commerce.

Unfortunately, the GST requires the agreement of India's states, which guard their revenue-raising powers jealously. It also requires an amendment to India's constitution, which bars states from taxing services, and prevents the central government taxing goods beyond the point of manufacture. The GST would allow the two layers of government to tax both goods and services, as they ripen along the value chain. Kautilya would be pleased.

On its first day, Mumbai's sealink was jammed with eager drivers. But once the novelty wears off, the congestion should ease. Likewise, it was inevitable that the new government's first budget would be overwhelmed by the weight of expectations. When Mr Mukherjee gives his next budget, perhaps the reform traffic may be running more smoothly.

Economist.com WORLD ASIA

Turkmenistan, gas and stability

# Elsewhere in Turkestan

Jul 9th 2009 | ASHGABAT
From The Economist print edition

**A modicum of normality breaks out**

Illustration by Claudio Munoz

WHEN Gurbanguly Berdymuhammedov succeeded Turkmenistan's megalomaniac president, Saparmurat Niyazov, in December 2006, there was little immediate sign of change. The former dentist and health minister announced he would follow in the footsteps of the late dictator, who styled himself "Turkmenbashi" or "Father of the Turkmen".

But more than two years on, much has changed, notably the personality cult surrounding the former president. Many golden statues in the capital, Ashgabat, have been taken down, though plenty remain, including the huge one that rotates so that Turkmenbashi always faces the sun. The late ruler's North Korean-style political philosophy, the *Ruhnama*, is no longer taught in schools.

A year ago Mr Berdymuhammedov reversed one of Turkmenbashi's more idiotic innovations by restoring recognisable names for days of the week and months of the year. January had been renamed Turkmenbashi and April was Gurbansoltan after his mother; Wednesday was "blessed day", followed by "virtue day". Turkmens couldn't remember what date it was.

An émigré returning after several years away says a gentle change is blowing across the country, like the wind that deposits black sand from the Karakum desert over Niyazov's white marble capital. Mr Berdymuhammedov sits on an ordinary chair for televised cabinet meetings, unlike Niyazov who occupied a gold throne. Public portraits of the new leader depict him with white roses and a white dove. Though criticising Niyazov is taboo, the official line is that his *altyn asir* (golden age) has been superseded by Mr Berdymuhammedov' s *taze galkynysh* (great revival).

Niyazov's mania isolated Turkmenistan. It distanced itself from Russia; took little part in the Commonwealth of Independent States, which links the former Soviet republics, and opted out of the Shanghai Co-operation Organisation of the other Central Asian nations, Russia and China. Demonstrating his go-it-alone philosophy, Niyazov renamed December "neutrality". The internet was banned and there was no foreign news on television, so Turkmens knew little of the world beyond the Karakum desert. Now the internet is available (though many sites are blocked) and satellite dishes are ubiquitous.

The opening up is needed. Turkmenistan sits on the world's fourth-largest reserves of natural gas. With no ocean-going ports, gas exports have to be piped through Russia, which pays less than $200 per 1,000 cubic metres—two years ago it was half this amount. Gas trades in western Europe for around $350.

At the moment the government has no choice but to sell to Gazprom. But it is not short of other suitors. China is building a pipeline which from 2011 will connect gasfields in Turkmenistan, Uzbekistan and Kazakhstan with China itself (through riot-torn Xinjiang). India, Pakistan and the European Union (EU) are also anxious to get their hands on Turkmen gas. To do so they, too, need to invest in pipelines.

Instability in Afghanistan and the West's distrust of Iran make foreign investment in a southern or south-eastern gas pipeline unlikely. January's gas supply hiatus between Russia and Ukraine makes it more likely that the EU-sponsored Nabucco pipeline will be built, though it will be 2015 at the earliest before it enters service. But while Nabucco could supply Europe with gas from Azerbaijan, it would not help Turkmenistan, which would also need a pipeline under the Caspian if it is to bypass Russia and Iran. That is fraught with difficulties as there is no seabed agreement between the riparian states.

Turkmenistan is now choosing a contractor to build an internal gas network. This will link new gas

discoveries near the Afghan border, including South Yolotan-Osman which ranks among the largest in the world, with Caspian basin fields. But Turkmenistan still needs a new export pipeline. The country's biggest foreign investor, Turkey, says it is ready to take part in the Nabucco project. If this can be linked to Turkmenistan, and if Mr Berdymuhammedov can resist Russian arm-twisting, then his country could become a big beneficiary of Russia's strained relations with Ukraine and of the uncertainty bedevilling Afghanistan and the Middle East.

**Political confrontation in South Korea**

# Long, hot summer

Jul 9th 2009 | SEOUL
From The Economist print edition

## South Korea's opposition is blockading parliament. The tactic may backfire

Reuters


THE ghost of Roh Moo-hyun is haunting South Korea. The former president committed suicide in May while under investigation for graft. His death has widened the split between the country's "progressive" forces that he represented and the conservative ones led by President Lee Myung-bak.

Mr Roh's backers set up a shrine to him across from Seoul's city hall, a traditional gathering place for protesters. The makeshift altar was promptly surrounded by a ring of police buses and later destroyed by conservative groups. Earlier this year, there was a series of violent clashes between the two sides inside the National Assembly. Parliament's summer opening was postponed because of Mr Roh's suicide. Now the former president's supporters are blockading the halls of parliament 24 hours a day, preventing deputies from getting into the chamber and any laws from being passed (see picture). Progressives are demanding the president apologise for Mr Roh's suicide, claiming that prosecutors who were investigating him were operating at Mr Lee's behest—a charge the president furiously denies.

Public discontent with Mr Lee and low approval ratings for his Grand National Party (GNP) have emboldened the opposition. Mono Research, a pollster, estimates support for Mr Lee and the GNP at just 33%. But the opposition is even less popular. The approval rating for the biggest opposition group, the Democrat Party, is just 21%, says Mono. The public's patience with quarrelling politicians is wearing thin and some members of the opposition fear that confrontational tactics may backfire. Ooh Che-chang, a member of the National Assembly and spokesman for the Democrat Party, admits the blockade is "not right".

The blockade could harm 700,000 or so "non-regular workers". Temporary and other workers who have worked for a company for two years are normally able to upgrade their contracts to permanent status. The governments wants to allow small companies (fewer than 300 workers) to delay the upgrade for 18 months because of the recession. The Democrats want only a six-month delay. With parliament blockaded, no decision can be taken and temporary workers could be fired as their contracts expire.

For the opposition, an even more emotive issue is a bill that would enable newspapers and business groups to take large stakes in television stations. The Democrats oppose this because they think that if the stations were owned by conglomerates or big media groups, then critical reporting of the government and big business would end. The bill will no doubt become law eventually because the GNP has a comfortable parliamentary majority. But Democrats want to postpone discussing it until the next session.

Cho Yoon-sun, the GNP's spokeswoman, hopes negotiations between government and opposition can lead to compromises over both issues. She says the government will not try and force its way past the opposition's blockade. But compromise is not in the air yet. The Democrats' Mr Ooh says the blockade will continue until the parliamentary session ends later this month. Some Democrats may even go on hunger strike. It is turning into a long, hot summer.

Indonesia's president re-elected

# No wonder why with SBY

Jul 9th 2009 | JAKARTA
From The Economist print edition

### The incumbent wins at a canter

FEW fireworks enlivened the televised debates between the three candidates in Indonesia's presidential election on July 8th, conducted in a mood of deference and courtesy. But the last debate on July 2nd saw something of a frisson. One of the challengers, Jusuf Kalla, attacked the incumbent, Susilo Bambang Yudhoyono (often called SBY), about a campaign advertisement. It called for the election to be completed in one round to save the 4 trillion rupiah ($400m) cost of the scheduled run-off in September. Mr Kalla complained that this implied that democracy, only 11 years old in Indonesia, had a monetary value.

Mr Kalla may have won the debating point. But he lost the argument. Unofficial "quick-count" projections, which have been accurate in other Indonesian elections, showed Mr Yudhoyono romping home in one round. He seemed likely to win about 60% of the vote, compared with about 13% for Mr Kalla, his vice-president, and 27% for Megawati Sukarnoputri, his predecessor. He also seemed likely easily to pass the other threshold—winning 20% of the popular vote in at least 17 of Indonesia's 33 provinces.

The losers may challenge the outcome. The electoral roll was conceded to be flawed, with some of the country's 176m voters missing from the list, and some duplicate names. Millions were disfranchised in parliamentary elections in April.

But nobody has levelled credible charges of deliberate manipulation, as opposed to incompetence by the independent election commission. And the Constitutional Court further cut the ground from under potential protesters' feet by ruling on the eve of the poll that unlisted voters could register on polling day using their identity cards. At polling stations in Jakarta, at least, the atmosphere was calm and orderly. Nationwide, there were few reports of trouble.

So Mr Yudhoyono, in 2004 the first Indonesian president to be directly elected, will be the first to be re-elected. Unlike in 2004, his Democratic Party is also the largest in the parliament, though he will still rule in coalition. His new vice-president, Boediono, a former central-bank governor, is a well-regarded technocrat. Mr Yudhoyono has held out the prospect of a cabinet stocked with other capable honest men.

Of the many explanations offered for the incumbent's popularity the simplest may also be the most convincing: he has done rather a good job. So soon after the chaotic implosion of the 32-year Suharto dictatorship in 1998, Indonesia seems politically stable and economically resilient, likely to show GDP growth of up to 4% this year. Idealists might frown that the best 11 years of democracy could throw up is a contest between the incumbent, his deputy and his predecessor. But it could have been so much worse.

Economist.com WORLD ASIA

**Banyan**

# Blind-sided in Asia

Jul 9th 2009
From The Economist print edition

**Russia does not exactly soar in its Asian backyard**

Illustration by M. Morgenstern

RUSSIA'S eagle, the country's diplomats remind you, has two heads, and one faces east. The trouble is, the Asiatic head seems blind. Despite the slump, Russia's eastern neighbours are still the world's most vibrant economies, yet Russia's links with Asia are weak. The country is the world's second-biggest oil exporter and its biggest gas exporter, yet it sends just 3% of its energy exports to oil-hungry Asia. Trade and investment in eastern Siberia and the Russian Far East fall far short of their potential, and the grim dilapidation of cities like Vladivostok and Khabarovsk is a shock to anyone from Asia's fast-moving metropolises.

Russia's Asian diplomacy also underwhelms. Its most obvious manifestation is as a member of the six-party talks aimed at getting North Korea to give up nuclear weapons. Russia has much at stake. But North Korea mocked the talks by flouncing out, leaving Russia (and the four others) with nothing to show for their efforts. Elsewhere, Russia takes pride in hosting the Asia-Pacific Economic Co-operation (APEC) summit in 2012, in Vladivostok. Yet there is no hiding that Russia is a bit player in regional trade and that APEC is A Perfect Excuse to Chat.

If Russia has a trade policy towards Asia it is to sell arms to all-comers. But its own lack of hard power in the region is reinforced by the view over Vladivostok's once-famous Golden Horn. Here is the 150-year-old home of Russia's Pacific fleet, as well as the terminus for the trans-Siberian railway, oldest symbol of Russia's Pacific aspirations. These days the run-down port is half-empty.

Russia's standing in Asia is in contrast to its claims of advancement elsewhere. Under Vladimir Putin, the country reversed its post-Soviet decline to re-emerge, it seemed, as a world power. A shattered economy recovered, accompanied by a strong state. Russia spread its influence in its near-abroad and flexed its muscle, both through energy intimidation (Ukraine, Kyrgyzstan) and military intimidation (Georgia). President Dmitry Medvedev has gone further, using naval clout in the South Atlantic as proof that Russia is returning to great-power status. The agreement over cuts in nuclear arsenals which Mr Medvedev reached with Barack Obama in Moscow this week only seemed to reinforce the point by reminding the world of the Cold War's superpower talks. Yet Russia's new national-security strategy, published in May, talks about the country's ambitions as a world power, but, except for North Korea, signally fails to mention the Asia-Pacific region.

Russia's first problem is an elemental one: the acreage that defines Russia as an Asian power in the first

place. The region suffers disproportionately from Russia's demographic curse—a 142m-strong population shrinking by 700,000 a year because of low birth rates and vodka-sodden ill-health. Russians were often forced to go to Siberia in the first place and are now upping sticks in the east and returning to the European heartland. The population density in the Russian Far East is barely one person per square kilometre. Across the Amur river in China, it is 140 times as much. Russians sometimes worry that they have only a tenuous hold on their vast eastern possessions. While some call for immigration to revive the region, demagogues whip up a new yellow peril, divining a Chinese plot to win back former possessions by sending people over the border.

The irony is that though the region has always been the subject of fantasies of great wealth, mineral discoveries have now given substance to those dreams. Besides, huge Chinese, South Korean and Japanese markets sit nearby, eager to secure supplies of energy. Russia says that over the next 15 years it will increase its share of energy exports going to Asia to 30%. Construction of a new pipeline from East Siberian oilfields to the Pacific has begun. Yet some Russians doubt that the state will muster the money and zeal needed to tap new sources fully. Such despair is not new. Dostoyevsky wrote of the Amur region: "If only Englishmen or Americans lived in Russia instead of us!...Oh, they would have opened up everything: the metal ores and minerals, the countless deposits of coal."

Foreigners in theory are ready to help, but two obstacles exist. One is Russia's state-led energy strategy. After the state forced them to tear up existing joint-development deals, foreign energy companies are cautious about signing new ones.

Even less tractable is Russia's territorial dispute with Japan, the obvious country to open up the Russian east for development. In the closing days of the second world war, the Soviet Union seized the four southernmost Kurile islands that Japan claims as its own and calls the Northern Territories. Settlement of the dispute, which both sides say is overdue, could be the official cue for a wave of Japanese investment. Territorial compromises have been floated. Yet neither countries' leaders are willing or able to make the concessions needed to strike a deal.

## One-China policy equals Asia policy

So Russia's chief Asian policy boils down to a China policy. Here, it has repaired what was once a deep Sino-Soviet split. At an official (though not grass-roots) level, ties are close. Russia has enthusiastically backed China's crackdown on the hapless Uighurs, for example. The new entente has been underpinned by heavily state-driven models of economic development on both sides. And China is the natural market for future energy exports to Asia. But if China becomes Russia's only eastern customer, it may become uncomfortably powerful.

More than that, Russia's regional aspirations may be thwarted by its uncritical friendship with China. Russian support for China has even extended to a clear backing for China's claim to Taiwan. Countries that do not care for an Asia dominated by China view this kind of expression with concern. And Russia itself may come to repent if it encourages a rising China to behave aggressively abroad. That would, after all, do nothing to ease Russia's sense of vulnerability in its far eastern lands.

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MIDDLE EAST & AFRICA

**Trouble in the United Arab Emirates**

# The perils of autocracy

Jul 9th 2009 | ABU DHABI AND DUBAI
From The Economist print edition

**When things go swimmingly, few people seem to mind being run by benevolent autocrats. When things get sticky, they are less obliging**

AP

IT WAS once hailed as a miracle. New cities, even new islands, were springing out of the desert or the shimmering turquoise sea. Nowadays, ten months after the financial crisis came crashing in on the United Arab Emirates (UAE), nearly destroying its shiniest component, Dubai, hundreds of cranes and dredgers have yet to resume work. The Queen Elizabeth II, once the world's smartest liner, due to become yet another posh Dubai hotel, is a sleeping quayside hulk. Nothing is happening on three of the most recently man-made islands shaped like palm trees off Dubai's coast that were the latest flashy projects of Nakheel, the emirate's shaky real-estate developer.

These days, despite defiant protestations of resilience, no one seems to know when the sweet breeze will return. The UAE is still in the doldrums. For the first time since the seven Gulf statelets joined together as a union in 1971, people are beginning to mutter—rather quietly, for sure— whether there may be something amiss with the autocratic, opaque system that hitherto seemed to work so well behind closed doors. "Nobody really knows what any of the statistics are," says a Western analyst. "We haven't seen the half of it yet," says a Western banker, referring to the debt and the possible defaults. It is notable that almost nobody in business or government is prepared to talk publicly. Cohorts of public-relations people surround the bigwigs and shield them from scrutiny.

In the past few weeks it has become clear, nonetheless, that the bottom has yet to be reached. Standard & Poor's (S&P), a credit-rating agency, has issued a string of recent gloomy assessments, downgrading four Dubai-based banks and noting that "the risk to Dubai's economy has increased as the real-estate sector has entered a sharp correction period." Property values are still about half what they were a year ago.

Some foreign building and dredging companies have not been paid for months, and some Dubai companies are offering to pay them only partially. S&P grimly notes the "increased uncertainty regarding the government's willingness to provide support to Nakheel, a key government-related entity with sizeable repayments coming due at the end of this year." The amount is $3.5 billion. A visiting British trade minister took the rare step, on July 4th, of publicly declaring, while insisting that Dubai would bounce back, that British contractors and suppliers "need to be paid". Earlier this year a leading Dubai figure said that the statelet's consolidated debt was around $80 billion, but no one has issued a detailed breakdown of accounts; only a minority of Dubai companies are listed. Others say that the true sum of debt may be closer to $120 billion.

In February Dubai's department of finance issued the first $10 billion chunk of a bond totalling $20 billion to help stave off the creditors, open new lines of credit and reschedule debt. Now, at a time when international banks are still loth to lend, it has been reported that the second chunk will be guaranteed by the UAE's government. More may still be needed.

It is not clear who is in charge—apart from Sheikh Mohammed bin Rashid al-Maktoum, Dubai's ruler (pictured above), whose big interest is racehorses. He appointed a respected local man, Nasser al-Shaikh, to take over the department of finance and sort out the crisis. It was reckoned that, for a start, he would be empowered to identify the size of the debt, both commercial and government (often one and the same) and the extent of Dubai's toxic assets. But in May he was summarily and mysteriously sacked. Some think he was blocked from looking too closely into the accounts at Nakheel, among other firms. Otherwise the old-guard management of Dubai—and the UAE—is still pretty intact. No one has been held responsible.

## Putting your hands over your ears

The two buzz words in Dubai's business and media circles are "denial" and "bail-out". A persistent complaint is that the authorities—in particular, the ruling family of Dubai and its acolytes, led by Sheikh Muhammad—took far too long to recognise the gravity of the crisis when it broke in September. "They were splashing about in the water when they should have been swimming across the channel," says another Western banker. In October Nakheel was still parading grandiose development schemes. It was not until January that Sheikh Muhammad summoned Dubai's top businessmen and ministers to take stock and plan a recovery. For months the Maktoums seemed to be in denial.

In the short run, the much richer and more conservative state of Abu Dhabi, with 90% of the UAE's oil reserves, will bail out its miscreant, extravagant neighbour, along with the other five, poorer statelets if they need help too. "In the long run, Dubai has enough assets to tide it over," says a banker in Abu Dhabi, pointing to Dubai's huge container trans-shipment business, its airline, aluminium smelter, tourism, and role as a regional services hub. Above all, Dubai and Abu Dhabi are too enmeshed to allow one part to fail.

Indeed, the Dubai disaster may prompt Dubai's Maktoum family and Abu Dhabi's ruling Nahyans to strengthen the federation and work towards a system of greater accountability and openness. A half-appointed Federal National Council is toothless, though it can now call ministers before it. The legal system, including commercial law, is weak; there is no proper bankruptcy code; there is no real tax base— nobody pays tax on his personal income.

Above all, in the words of a longtime adviser to the government, "you have a confusion between government and commercial operations. There is nobody in Dubai in government who isn't first and foremost a businessman." There are "massive conflicts of interest" across the board. "There are no checks and balances…the incentives for saying nothing are great."

Abu Dhabi is ahead of Dubai in terms of government openness and efficiency. But in both the emirates all the big decisions are still taken behind closed doors. In the mild words of a diplomat, "neither Abu Dhabi nor Dubai are very good at clarity in decision-making." Vital decisions are often not put in writing.

The aim of the two ruling families has been to modernise and open up the economy without modernising or opening up the politics to the extent that the people might one day dispense with their royal rulers. In the short run, there seems little chance of that happening. The expatriates who manage much of business have little say in the running of the place, but are generally content to live well and ask no questions about delicate matters of state. An English-language newspaper, the *National*, backed by the Nahyans, has opened a healthy space for discussion, though royal scandals or provocative words like "bail-out" or "in denial" are virtually taboo.

The indigenous emiratis, who count for less than a fifth of the 5m people living in the UAE, have hitherto been mollycoddled by benevolent rulers. In a couple of years, a recovery may ensue. A resurgence of oil prices is helping. But if the economy gets stuck, the glory days, at least of the Maktoums, may be numbered.

### The United Arab Emirates and Sudan

# An odd deal over land

Jul 9th 2009 | JUBA
From The Economist print edition

**Are Gulf Arabs taking a chunk of South Sudan for themselves?**


THE pristine grasslands of south-eastern Sudan may be the largest trackless swathe of Africa. The annual migration of wild game across the Boma plateau may equal the more famous annual migration through Tanzania's Serengeti plains. Yet for the next 50 years, under a recent discreet deal, some 16,800 square kilometres (6,180 square miles) of this wilderness will become the estate of a company which—it is presumed—has won approval from the ruling Nahyan family of Abu Dhabi, the richest of the seven statelets that make up the United Arab Emirates (UAE).

The leasing agreement was signed by a company called Al Ain National Wildlife after an earlier failed attempt by another company in the UAE to buy exclusive access to 6,500 square kilometres of the Serengeti plains in northern Tanzania. If well run, large slices of land bought up or leased by rich patrons may help preserve the area for future generations of locals. But some say the deal has been struck without the involvement of ordinary locals and say that aircraft registered in the UAE are already flying equipment to a camp in the Maruwa Hills to start building a resort.

Under the agreement, a copy of which was obtained by *The Economist*, Al Ain promises to build top-class hotels as well as the semi-permanent tented camps favoured by most up-market safari companies. Some conservationists wonder if the visitors may be looking for big-game trophies, despite a general ban on hunting in the south.

Other southern Sudanese discern strategic implications. They say the Emiratis, with their cargo aircraft, helicopters, road-building equipment, lorries and jeeps, may end up running an area of Sudan about as big as Denmark with little interference. They also wonder whether Al Ain and its contractors will employ Muslim security people from the north, who are generally distrusted by the Christian and animist southerners.

If Sudan's north and south return to war, as may happen if the southerners try to secede in 2011 under a north-south agreement signed in 2005, sceptical southerners say that northerners might try to use the airstrip to bring in troops and weapons, though there is no suggestion that Al Ain would be party to such activities. As things stand, Al Ain is apparently already able to fly aircraft from the UAE in and out of South Sudan with no restriction or inspection.

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**Iran's rebellious students**

# Go underground

Jul 9th 2009 | TEHRAN
From The Economist print edition

**On the surface, normality is returning. Underground, things may be different**

DESPITE a renewed crackdown by the security forces, Iran's students are looking for clever new ways to keep their campaign for democracy going. But it is a struggle. Nearly all foreign journalists, bar a handful of agency reporters, are being kept out, so that channel of communication is barred. Websites such as those of the BBC and Facebook are blocked. The text-message system has been stop-go. The authorities have randomly declared public holidays and told people to stay off the streets because of “unhealthy pollution levels”. Security men in plain clothes stop people, especially young ones, at crossroads, to check their bags and identities. Communication between Tehran and other big cities is similarly tricky; there have been reports of dozens of students being arrested at a university in the central city of Isfahan, a former capital of Persia.

The authorities have closed down Tehran's main university, where the Islamic Revolution began in 1979. Last month it witnessed bloody battles between police and students. Stone-faced security men now stand guard at the front gate, while other entrances have been padlocked. A small number of teachers and students favoured by the authorities are let in.

Final exams have been postponed until September, though a few were taken last month. Graffiti praising Mir Hosein Mousavi, the thwarted presidential challenger, have been scrubbed off, leaving a huge officially sanctioned mural depicting the Statue of Liberty hurling rocks at cowering women and children. Other centres of learning in Tehran, such as Amirkabir University of Technology and Sharif University, have also been locked down.

Many students say that all is lost. “At first, I was angry,” says one at Shahid Beheshti University. “Then I was disappointed. Now I just feel emptiness.” A recent graduate from the Iran University of Science and Technology says he and his classmates have lost hope. Above all, a sense of paranoia has taken hold. Large numbers of students enter university as a reward for joining the *baseej*, a vigilante militia that answers to the Revolutionary Guard, so the campuses are heaving with informers. Students are afraid to talk to foreigners. Some refuse even to glance at them.

The government has unnerved many young people by threatening to use deadly force on a larger scale. So far, it admits that a score of people have been killed. Human-rights campaigners say more than 2,000 people have been arrested across Iran. That includes perhaps a hundred senior people associated with Mr Mousavi or the pair of former presidents, Muhammad Khatami and Akbar Hashemi Rafsanjani, who have come out against Mahmoud Ahmadinejad and his mentor, Ayatollah Ali Khamenei, Iran's supreme leader. Tehran's police chief has admitted that more than 1,000 were arrested in Tehran alone but says that two-thirds have been freed.

## Green is naughty

In any event, the campaign is moving underground. A core of protesters is bent on keeping the torch burning, reminding fellow students that the revolutionaries of 1979 endured nearly a year of repression and street skirmishes before they managed to overthrow the shah. Today's protesters write subversive slogans on bank notes and pour green paint onto the streets at night, taking care to mix yellow and blue rather than buy the ready-made green stuff, whose sales are carefully monitored.

None of these tactics has made much of a dent so far. Everyday life in Tehran seems to be back to normal. Traffic is once again bumper to bumper. Mellat Park, one of Tehran's biggest, is full of families with children playing football. Coffee shops are again frequented by young people flirting, despite the demure veils.

But beneath the surface, a game of cat and mouse is under way. The government is still on edge, wary that unrest could resume. One date coming up soon is the end of the 40-day mourning period since Neda Soltan, a symbol for the campaigners, was shot dead while arriving at a demonstration in Tehran. E-mails calling for more demonstrations are still circulating. Public protest has dwindled but may not be over. The atmosphere, among students and other Iranians, is: “let’s wait and see”.

## Israel's economy

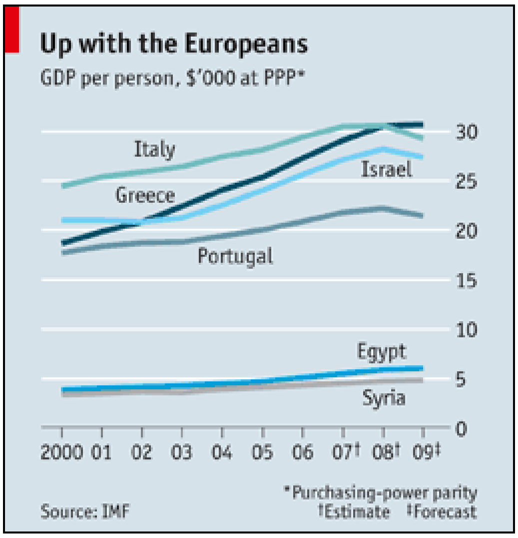
# The government says it's perky

Jul 9th 2009 | JERUSALEM
From The Economist print edition

**Israel's economy looks quite resilient**

YUVAL STEINITZ, Israel's finance minister, radiates confidence. Once a popular young left-wing philosopher, he is now a leading light of the right-wing Likud party, the main bit of Binyamin Netanyahu's coalition, which took office at the end of March. Israel's economy, he insists, can weather the global turmoil. "Nietzsche taught us, 'That which does not kill me makes me stronger'", he muses. "The recession has shown we're strong. Now we can turn the recovery to our advantage."

It is the job of a finance minister to talk up his economy. Even so, Mr Steinitz's optimism seems broadly justified, as he prepares to present a budget for this year and next. Israel's economy has grown by an average annual rate of 5% in the past five years. Its GDP per head is ahead of Portugal, a shade behind Greece and five times bigger than its neighbour Egypt (see chart).




Still, Israel is suffering with the rest of the world. Exports, which accounted for 44% of its GDP of $200 billion last year, have shrunk by more than a quarter since September. Foreign investment has dived. High-tech, one of Israel's biggest successes, is marking time. Tourism and diamonds have lost their glitter. Fewer buildings are going up. Nearly 8% of the workforce is jobless, up from 6% nine months ago.

"But the government has not had to step in and save any bank or insurance company or indeed any major company," says Mr Steinitz. Some economists say it was lucky for Israel that a big share-dealing scam in the 1980s encouraged governments, after bailing out a number of banks, to pursue conservative fiscal policies and tighten regulation. Now, apart from Bank Hapoalim, the country's largest, which has had to write off more than $1 billion in American mortgage-based securities and other toxic assets, Israeli banks have so far been clean. The central bank's respected governor, Stanley Fischer, a former top man at the IMF, monitors them closely. They have to hold more capital than banks in many Western countries. Their lending to commercial clients and to homeowners is generally cautious.

The government is spending a lot on building roads and schools to create jobs. It also proposes to drive out illegal foreign workers—300,000 of them, says Mr Steinitz—by heavily fining their employers. "Unlike the EU countries, we're not short of young people. If the foreign workers go, wages will rise and young Israelis will work in all kinds of jobs they balk at now."

Surprisingly, Mr Steinitz has raised VAT from 15.5% to 16.5% (but had to drop a proposal to levy it on fruit and vegetables), while embarking on a seven-year plan gradually to reduce company tax and income tax instead. "If I put money in ordinary peoples' pockets, they'll spend it on imported goods and foreign holidays," he says. "Our own economy doesn't produce consumer goods for them to buy. We make know-how and software, chips for Intel [a giant American maker of processors] and computers for irrigation, chemicals, stents for heart surgery and pilotless drones."

Mr Steinitz says Israel must make such products more competitive as the world economy recovers. He proposes to double government funding for research and development. No bank bail-outs, he argues, means he can keep the budget deficit down to 6% this year and 5.5% next. His "temporary" rise in VAT is meant to help offset a drop in tax revenue. "Other countries will be raising their direct taxes to cover their deficits just when our taxes will be coming down. In five or six years, Israel's company tax will be lower than Ireland's. Intel and others will think hard about that when they decide where to invest."

But Intel and others may not warm to the package deal that Mr Netanyahu struck three months ago with the trade unions when he was wooing the Labour party to join his coalition: scant hope now of trimming the bloated public sector or reducing its wage bill. “The entire recession has fallen on the private sector,” says a prominent financial commentator. “The public sector continues to be a bottomless sinkhole.”

The budget prescribes a cut of 5% in government ministries’ spending. But no one believes it will happen. The defence minister, Ehud Barak, who leads the Labour party, refuses to hear of cutting the military budget, an Israeli sacred cow. And as a sop to Shas, a religious party that is another needed partner in his coalition, Mr Netanyahu has reversed some of the cuts in child allowances he himself imposed as finance minister four years ago.

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**The Russia / America summit**

# Barack, Dmitry—and (offstage) Vladimir

Jul 9th 2009 | MOSCOW
From The Economist print edition

**A meeting of pragmatism, not warmth—with potential trouble still ahead**

EPA

THE body language said it all. When Barack Obama arrived in Moscow for his first summit with the Russian president on July 6th, he sat on the edge of his chair, his eyes fixed on his host, Dmitry Medvedev. Mr Medvedev sat back, revealing a mix of reserve and polite attention to what Mr Obama had to offer.

This scene reflected Russia's general response to Mr Obama. America made the first approach and offered to "reset" the relationship. Although suspicious of Mr Obama's intentions, Moscow nevertheless did not want to miss a chance. As *Moskovsky Komsomolets*, a tabloid, put it: "Why should we make a step towards Obama? Not least, because it is in our interest. Having won a war against Georgia, we confirmed our status as a great power, but ended up in isolation. Of course, we could live like this. But why not stop this isolation without ceding past achievements?"

Stiff with security, Moscow displayed no sign of the Obamamania seen in other capitals. Muscovites did not line up to catch a glimpse of the man. One national television channel led the evening news with Michael Jackson's funeral, not Mr Obama's visit. A poll suggests that 36% of Russians are indifferent to Mr Obama; only 12% feel sympathy towards him.

But Mr Obama came to Moscow for business, not love. He managed to do as much as could have been expected. The two sides agreed in principle to cut their nuclear arsenals by roughly a quarter in seven years. For Mr Obama this was part of a vision of a non-nuclear world. For the Russians, it was an opportunity to preserve some semblance of nuclear parity. Given that Russia's stockpile is ageing fast, it will not have to do much to reach the target. The Russians and Americans also agreed to renew military co-operation and work on non-proliferation. A dozen American aircraft a day will fly through Russian airspace carrying troops and equipment to Afghanistan. This will save time and money, but also make Russia's southern border more secure. "They are real things, not fluff," says Michael McFaul, Mr Obama's top Russia adviser.

Yet the bigger test will come over Iran, missile-defence plans (see article) and countries in the former Soviet space. The improvement in relations is so fragile that it may not withstand the strain of potential Western action in Iran. Russia does not want Iran to have nuclear weapons, but nor does it want to lose influence for America's sake. "Russia does not want to fight with America, but it is not prepared to make concessions to America either. Moscow's general policy is one of disengagement," says Ivan Safranchuk, an adviser on disarmament and foreign relations.

Mr Obama’s speech at the New Economic School in Moscow was an attempt to engage Russian society without trying to lecture it. He addressed the more neuralgic elements in Russia’s self-perception. He praised the Russian people for ending the cold war. He insisted that America wanted “a strong, peaceful and prosperous Russia”. But he stressed that “pursuit of power is no longer a zero-sum game” and that Georgia and Ukraine were entitled to their sovereignty. He talked up the rule of law and freedom of speech “because they are moral, but also because they work”. And he added pointedly that “governments which serve their own people survive and thrive. Governments which serve only their own power do not.”

Mr Obama’s speech was broadcast live by only one cable TV channel with limited reach. The main channels highlighted his endorsement of a “great Russia” and managed to turn his comments about “dominating and demonising other countries”, a reference to Russia’s behaviour to its former republics, into a case of American self-criticism. Even students remained largely indifferent to Mr Obama’s speech. “I take what he said on board, but I am not going jump to a conclusion,” said one.

Such a reaction reflects the culture of cynicism and nationalism that has flourished in Russia in recent years. But it is also the result of Russian disillusionment with America. Vladimir Putin, Mr Medvedev’s prime minister, spent much of his two-hour breakfast with Mr Obama venting Russia’s grievances over America’s policy. He blamed George Bush for letting Mikheil Saakashvili, Georgia’s president, twist American support into a green light for a war. But he allowed his talks with Mr Obama to be twisted by his own side. According to Yury Ushakov, Mr Putin’s chief foreign-policy adviser, “President Obama pledged to consider the regional significance of these countries for us.”

This line was amplified by Russia’s main TV channel, which presented it as America’s concession and Russia’s victory. It quoted Vyacheslav Nikonov, Russia’s main pro-Kremlin commentator, as saying: “All the sanctions that were imposed against Russia after the war in August 2008 are in the past. This shows that America realises the necessity to work together with the Russian Federation. America has understood what was going on last August. Today nobody in Washington would shake Saakashvili’s hand.”

Mr Obama has few illusions about Mr Putin. “I found him tough, smart, shrewd, very unsentimental, very pragmatic. And on areas where we disagree, like Georgia, I don’t anticipate a meeting of minds anytime soon.” By the same token, Mr Obama said he trusted Mr Medvedev and found him “straightforward and professional”.

Taking Mr Medvedev seriously and declaring his interest in “dealing directly” with him may bolster Mr Medvedev’s status. But playing up the distinction between Mr Putin and Mr Medvedev could also be counterproductive. The differences between the two are often notional. Mr Medvedev nominated Mr Putin’s chief ideologue, Vladislav Surkov, to a bilateral commission on civil society. And Mr Putin may yet resume the presidency. His recent grandstanding looks suspiciously like the start of a presidential campaign.

Mr McFaul concludes that “we did not solve everything in two days. That would be impossible. But I think we came a long way in developing both a relationship that advances our national interest with the government and laying out a philosophy about foreign policy.”

In his latest stunt, after meeting Mr Obama, Mr Putin swapped his business suit for a black sports jacket and trousers and appeared at a gathering of Russia’s leather-clad bikers, the “Night Wolves”. After a long discussion with a tattooed giant called “Surgeon” and a boast about his own Bond-style motorbike wheelies, Mr Putin waved them off to Sebastopol, a port in Crimea, Ukraine, armed with a Russian tricolour.

## America and eastern Europe

# Not captivating now

Jul 9th 2009
From The Economist print edition

**Eastern Europe watches nervously as America improves relations with Russia**

WHEN he returns home, a routine task in President Barack Obama's in-box will be to proclaim the third week of July "Captive Nations Week". Established by Congress in 1959 to show American solidarity with countries trapped inside the Soviet empire, it amounts nowadays to little more than a press release and a couple of parties. But it echoes a decades-old American commitment to the region's freedom and security, sealed by NATO's expansion to include 12 ex-communist countries.

That has created both loyalty and expectations. Eastern Europe sent troops uncomplainingly to Iraq. Several countries have soldiers in Afghanistan: indeed, some smaller ones have suffered remarkably high casualties there, largely unacknowledged by their bigger allies. And Poland and the Czech Republic agreed to host a new missile-defence system to counter a possible threat from Iran. This irks the Kremlin, which claims to fear American encroachment in its own backyard.

The east Europeans find Mr Obama an easier ally than his predecessor, George Bush. They are broadly pleased with his trip to Moscow. Unlike Mr Bush, who looked into Vladimir Putin's eyes and got "a sense of his soul", Mr Obama was not gulled into giving Russian leaders cloying praise. He brushed off attempts to trade influence in eastern Europe for help on issues such as Iran.

But on eastern Europe's own future, the new administration's touch is less sure. It is giving out mixed signals on the missile-defence deal signed by its predecessor. Polish and Czech leaders who argued in favour of the scheme feel exposed. One says, disapprovingly, that America's wobbles are "unimperial". Even tacit linkage between delaying or scrapping the scheme and pleasing Russia will heighten those worries.

Talks on a plan to put a battery of Patriot air-defence missiles in Poland are bogged down in arguments over cost, whether they will be armed and the legal and tax status of the Americans who come with them. Promises of help to modernise the Polish armed forces ("we provide the boys, you provide the boots" as a Polish official once put it) have proved frustratingly empty.

The region's biggest fear is the health and credibility of NATO. The new members want the alliance to work on proper military planning, explicitly taking Russia into account as a potential threat as well as a partner. That has been taboo since the early 1990s and is opposed by some west European countries with close business ties to Russia. But such issues are low down the White House's to-do list. "Obama doesn't have a Europe policy. But neither does Europe," says an east European leader wryly.

French sovereign debt

# Of human superbondage

Jul 9th 2009 | PARIS
From The Economist print edition

**Why is Nicolas Sarkozy so eager to issue a superbond?**

AP

**What to buy with a superbond**

MOST governments borrow because they have projects or commitments that they need to pay for. Nicolas Sarkozy seems to be turning this logic on its head. Last month the French president announced plans for a superbond. This week he appointed two former prime ministers, Alain Juppé, a Gaullist, and Michel Rocard, a Socialist, to head a commission for four months to think about what to do with the money being raised.

Mr Sarkozy wants the two grandees to reflect on "priorities that justify an exceptional investment effort to prepare France's future." François Fillon, his prime minister, has written to all parties to ask for ideas. The bond will not be launched until 2010, and no amount has been specified. Mr Fillon says part will be open to individual investors: the French are among Europe's thriftiest folk. The areas that could benefit from the money include research, innovation, renewable energy, education, health, biotechnology and infrastructure.

Why this sudden need for citizens' cash? The government often issues bonds to individuals, and raises money with ease from the capital markets. This year, analysts expect it to borrow €180 billion this way. The market in French-government debt is highly liquid. The interest-rate premium of French bonds over German ones is lower than, say, that of Greek, Irish or Spanish bonds, showing that markets rate French debt highly. "The French government does not need this bond issue," concludes Moritz Kraemer, head of European sovereign ratings for Standard & Poor's, a rating agency, which has kept its highest rating for France. "It can raise almost any amount it needs from the markets."

The best guess is that the superbond is motivated by politics, not finance. Yet Mr Sarkozy can hardly present it as a desperate crisis measure, a modern-day call for households to send in saucepans to help the war effort. Elysée advisers talk instead of a "people's bond" that ordinary citizens can subscribe to, knowing—unlike with normal bonds—just what the money will go on. The idea seems to be that French savers buy into a vision of a shiny new country of the future, full of gleaming campuses and high-speed trains, as a way of building confidence in Mr Sarkozy's ability to steer the economy through recession. It bears the stamp of Henri Guaino, the president's interventionist speechwriter.

French savers seem hesitant, however. Polls suggest that only a minority approve, and that less than 20% would consider subscribing. To guarantee success, the government will have to offer generous terms. A five-year bond just issued by EDF, an energy company, raised €3 billion from individual investors, three times what the firm had expected, but only by paying a 4.5% annual return. In 1993 the "Balladur bond" also drew more investors than expected, thanks to a high interest rate. But it cost a lot in the long run.

As it is, thanks to years of financing a heavy state and generous welfare system, French public debt is expected to reach 75% of GDP in 2009, when the budget deficit will be over 6% of GDP. Which hints at another possible reason for the bond. A showdown looms with other European Union members, especially Germany, over the stability-pact rules for reining in budget deficits. Mr Sarkozy has tried to argue for differential treatment of "good deficits" that finance investment, and "bad deficits" that simply go on running costs. He may be hoping that a successful superbond, issued to pay for investment, will give him popular backing to strengthen his case with fellow Europeans.

**Unemployment in Spain**

# Two-tier flexibility

Jul 9th 2009 | MADRID
From The Economist print edition

**How the burden of adjustment in Spain falls on the underprivileged**

Getty Images


LIFE is looking up for metalworkers in Cuenca, east of Madrid. They have won a pay rise of 3% in real terms. In a country with falling GDP and unemployment of 18%, that is no small feat. Yet it is not unusual. Spain's centralised wage-bargaining system awarded real pay rises of 3.5% in May, the highest in a dozen years. Spaniards in work might be forgiven for concluding that recession is beneficial.

The fate of Spanish workers is a story of contrasts. Some have never had it so good; others have never had it so bad. Spain has the European Union's highest unemployment and one of its less generous welfare systems. It has shed 1.2m jobs in a year. It will soon have as many jobless as Italy and France combined. Pay rises for some have led employers to cut the jobs of others. Two-thirds of workers have armour-clad permanent contracts. But the rest are on short-term deals. They are the people now on the dole.

This two-tier labour market divides workers into a privileged group cocooned from the reality of recession and the disadvantaged on temporary contracts, in unemployment or in illegal jobs. Employers do not invest in training short-term workers and are wary of hiring on permanent contracts. At any hint of a slowdown they shed the short-timers. "That the crisis has hit Spanish employment disproportionately is due to the catastrophic way the labour market works," argues Luis Garicano of the London School of Economics.

Professor Garicano is one of a group of 100 economists who have called on the Socialist prime minister, José Luis Rodríguez Zapatero, to set about labour-market reforms. The calls have fallen on deaf ears. Talks between unions and employers stalled when the bosses proposed to cut the cost of laying off privileged workers. The government retorted that this was a "red line" it would not cross. Mr Zapatero will not be taking on the unions.

Nor does he seem able to change Spain's low-skilled economy. Unions and employers have spent a year failing to reform it. Inertia rules, for several reasons. One is that Mr Zapatero does not believe reform is a priority. Another is that he does not want to provoke a general strike. A third is that his minority government struggles to win parliamentary votes. One day of talks with potential allies recently saw tax rises on high earners announced and withdrawn within six hours.

Opponents of reform argue that labour-market rigidity did not get Spain into its mess. Toni Ferrer, chief negotiator for the General Workers Union says real-terms pay rises averaged just 0.5% a year since 2005. Today's wage rises, he says, are based on official forecasts of 2% inflation, compared with slight deflation now. "The problem is not labour regulation," says Mr Ferrer. "What needs changing is the economic model." That model produced the housing bubble that is largely responsible for Spain's woes.

Mr Zapatero seems bent on spending his way out of trouble. The budget deficit is heading for 12% of GDP. Fallout from the housing bust has forced him to set up a €99 billion ($138 billion) bank-rescue fund. The banks, especially the savings banks, are sitting on a pile of bad loans. Many of the newly jobless are unskilled construction workers, mostly on temporary contracts. They are now adding to banks' woes by defaulting on mortgages. Recovery depends on getting them back into work.

Rising unemployment does not mean that Spain's economy is

shrinking faster than others. This year's predicted drop in GDP of 3.2% is less than the European average—and far below Germany's 5.4% drop. But Germany has shed fewer jobs (see chart). With a large pool of unemployed, Spanish firms may be able to rehire at lower rates. A two-tier labour market provides flexibility, but on the back of an underclass of temporary workers. This might strike most socialists as unjust. But Mr Zapatero seems happy to keep it that way.

**Bulgaria rejects its government**

# Borisov's turn

Jul 9th 2009 | SOFIA
From The Economist print edition

**Bulgarians have elected a popular but unpredictable new leader**

EPA

A mayor turns into a prime minister

EXASPERATED voters boot out a bad government and install an unknown one. That is the Bulgarian election in a nutshell, after the defeat of the Socialists (ex-communists) by a centre-right populist party led by Boyko Borisov, a cigar-chomping ex-bodyguard. Citizens for European Development of Bulgaria, known by its Bulgarian acronym of GERB, took 39.7% of the vote on July 5th, entering parliament and government for the first time.

Few doubted that the Socialists would lose or that GERB would do well. Bulgaria's leaders have been the subject of humiliating criticism by the European Commission, worried about endemic corruption and links between organised crime and some bits of government. Mr Borisov has been a lively mayor of Sofia who has shaken up the capital's administration. But few expected voters' discontent to be so strong. Turnout was high, at 60%. Mr Borisov won support from change-hungry voters, even if they felt queasy about his headstrong personality and spotty past.

Instead of needing to broker a coalition with the Socialists, Mr Borisov will now be able to govern with a smaller coalition partner. His most likely ally is a "blue coalition" of two centre-right parties. But Mr Borisov says he will talk to everybody, even Ataka, a racist far-right party that took 9% of the vote.

Denouncing corruption is one thing. Extirpating it is quite another. Mr Borisov says he wants to investigate and jail his predecessors. But few expect quick results. Bulgaria's rich and powerful have shown remarkable agility in dodging the lethargic courts. Mr Borisov has already won plaudits by appointing outside professionals to his cabinet, including Simeon Djankov, an economist at the World Bank who will be the new finance minister. Mr Djankov will have to deal with plunging tax revenues, a GDP fall of perhaps 5% this year and a huge current-account deficit.

A good way to start would be overhauling the country's shambolic public administration. Another idea would be to look into the overlaps between politics and business in the Movement for Rights and Freedoms, which represents the country's Turks. A fixture in government for some years, this party has been criticised by anti-sleaze campaigners, especially those concerned with the misuse of EU funds. The party's unabashed influence-peddling has increasingly scandalised Bulgarians. Its leader, Ahmed Dogan, has publicly boasted of his ability to channel state funds and wield political power.

Such displays of arrogance dented the Socialists' image, as did worries about the pervasive hold of the communist-era secret services and rising Russian influence, notably in energy. The outgoing government's counterattack largely failed to dispel these concerns. It consisted mainly of tweaking the electoral law to penalise small parties and political independents, helped by a costly series of negative television ads. The coalition's unpopularity sent its other member, the liberal party of former King Simeon, out of parliament.

In its place came a new party campaigning against corruption, Order, Law and Justice. Its leader, Yane Yanev, has a habit of producing classified information to back up his claims. That has prompted accusations, which he denies, that he is a front for the secret services. Bulgarian politicians may not yet be able to govern cleanly. But voters have certainly shown that they want it.

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Croatia's new prime minister

# The dilemmas of Diocletian

Jul 9th 2009 | DUBROVNIK
From The Economist print edition

**The problems pile up for a new female prime minister**

BUSLOADS of Japanese tourists collapse exhausted in their hotel lobbies; Serbs moon about, fretful that their cars may be vandalised; just offshore, cruise ships afford their passengers one of the finest sights in the Mediterranean. Although it is early in the season, people in Dubrovnik who live off tourism are breathing a sigh of relief. Despite the economic gloom, this season may not be the catastrophe some feared.

Nobody in Croatia thinks this is a time for complacency. So when Ivo Sanader, without warning, resigned as prime minister on July 1st, the opposition was quick to accuse him of quitting just as the country faced its worst economic crisis in years. A week later Mr Sanader's resignation is still unexplained. He was angry that European Union leaders have not stopped Slovenia from blocking Croatia's EU accession talks over a trivial border dispute—but nobody thinks that merited his departure. He said he was not ill. Nor was he quitting to run in next year's presidential election. It seems instead that Mr Sanader was just fed up—like Diocletian, the Roman emperor who also hailed from Split and retired there to grow cabbages.

Croatia is awash with gossip. Vesna Pusic, an opposition leader, demanded to know if blackmail was involved. Many talked of a political crisis after Mr Sanader's departure. But in a smooth transition his deputy, Jadranka Kosor, was confirmed as the new prime minister this week. She is a former journalist and presidential candidate, a poet and a woman known for her loyalty to Mr Sanader and his predecessor as party leader (and former president), Franjo Tudjman. “A wingman”, sniffs Ines Sabalic, a columnist.

There is no underestimating the task she faces. A meeting at the end of June to discuss Croatia's progress towards EU accession was cancelled as there was nothing to discuss. The Slovenes are not the only problem. There are also the so-called artillery diaries that are said to show exactly what the Croatian army aimed at when they defeated Serbian forces in Krajina in 1995. The Croatian government has said these records either do not exist or are lost. But the chief prosecutor at The Hague war-crimes tribunal is not convinced. If he remains so Croatia's EU bid will stay stalled.

And then there is the economy. April's budget was based on rosy forecasts that the economy would shrink by only 2% this year. The first task of Ms Kosor's government will be to prepare a more realistic one. Zeljko Rohatinski, governor of the central bank, thinks GDP will fall by almost 5% this year, and some economists believe that even this is far too optimistic. Ms Kosor vows not to shirk from public-spending cuts. But President Stipe Mesic thinks her government will not last long. Croatia's problems are piling up—and the rest of the western Balkans looks on nervously.

## Charlemagne

# A Belgian national champion

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From The Economist print edition

**A terrible lesson from a terrible painter**

Illustration by Peter Schrank


IN MARCH 1850 Antoine Wiertz, an artist, wrote to the newish Belgian government offering a swap: his largest paintings in exchange for the construction of a "huge, comfortable and well-lit" studio. Somewhat surprisingly, his proposal was accepted. The interior minister, Charles Rogier, agreed to hand over a large sum of money to build a studio that would, after Wiertz's death, display his works in perpetuity. Rogier's was a terrible decision even at the time. For today's governments, looking on 160 years later, it stands as a masterclass in maladministration.

Wiertz's timing was good: a mere 20 years after a revolution against Dutch rule had brought Belgium into being, the young kingdom was in search of national champions. His vast paintings earned the accolade of "giant" when shown in Rome and caused a sensation in Brussels, Antwerp and Ghent (though Parisian critics were less kind). It was reported that the violence of his Homeric battle scenes left children wailing in fear. His "Two Young Ladies"—a naked beauty contemplating a skeleton—teetered just on the right side of smut for 19th-century tastes. Wiertz, who compared himself to Rubens, admitted that some accused him of excessive pride. This was unfair, he assured the minister. "To judge a painter, you have to wait at least two centuries."

For a while, posterity's judgment was kind. In 1927, six decades after his death, his studio received 46,000 visitors. Belgian art-lovers thrilled to the melodrama of "Premature Burial", in which an anguished figure peeps out from a coffin in which he is trapped. They relished the social commentary of "Hunger, Madness and Crime", depicting a destitute peasant waving a bloody knife as the leg of her murdered infant peeps from a cooking pot. Nor was patriotism forgotten. In "Ravishing of a Belgian woman", Wiertz breaks with convention by equipping his heroine with a pistol (although not with any clothes). She duly shoots the soldier molesting her, causing his head to explode, an event Wiertz depicts in gory detail.

Alas, modern audiences have proved less tolerant of such cod-Gothic nonsense. In recent years the Wiertz Museum has attracted an average of just ten visitors a day, many of them dragooned in school parties (the museum is currently closed for a few months, while its roof is replaced). The curator, Brita Velghe, concedes that Wiertz is "no Rubens", but defends the museum as a rare example of a 19th-century studio, with a unique history. Ms Velghe adds that Wiertz might flourish today as a performance artist (he once turned up in Paris with a 28 square-metre painting of the Trojan wars, demanding that it be displayed in a tent outside the Louvre).

When Wiertz died in 1865, few seemed to imagine that his estate might one day become a burden. Public opinion, politicians and the press called him a Belgian hero of the arts, to be ranked alongside such figures as Gustave Wappers, a painter of patriotic and historical works. Today, it takes some rummaging in an art dictionary to find a trace of either man. Tastes change. But the difference between the two Belgian artists is instructive. Wappers achieved material success in his lifetime: he was made a baron and painter to the king. But his physical legacy is not overwhelming. His most famous work, a large and busy depiction of the 1830 revolution, still hangs in Brussels's Royal Fine Arts museum. Few visitors have a clue what it represents, or linger long to study its confused jumble of wounded patriots, pike-wielding peasants and Belgian flags.

In contrast, Wiertz died poor, but the Belgian state is legally stuck with all 220 of his works—dreadful though most of them are—and an obligation to display them forever. In 1866, when Belgium's parliament gratefully accepted Wiertz's estate, it bowed to the artist's strict conditions that his paintings should never be moved, loaned or placed in storage, but should remain "invariably fixed" to the walls of the studio Belgium had built for him.

## Chimerical champions

The curious tale of Antoine Wiertz, perhaps the worst painter to have a government-funded museum all to himself, at least in the free world, holds several lessons for modern-day politicians. Those lessons are especially relevant right now, as politicians pour billions into firms buffeted by the recession.

For a start, national champions are not always as durable as they appear, even when politicians, press and public are all clamouring for an institution to be rescued with copious state aid. People are bad at second-guessing posterity. Indeed, those who sound most convincing about the future are often merely describing present-day trends, or else they are just articulate lobbyists for today's success stories.

Also, once the state displaces the market and takes responsibility for a commercial enterprise, whether a bank, a carmaker or a struggling painter with a gift for the gab, it can be surprisingly hard for it to back out again. And one should always beware of appeals to chauvinism and local pride. After a hostile reception by critics at the Paris salon of 1839, Wiertz published a furious call for Brussels to "rise up" and become "capital of Europe", leaving Paris a mere "provincial" town. He was promptly awarded a medal by the Brussels authorities.

Wiertz was not always wrong about posterity. When he wrote to the government to ask for funds to build his studio in what was then an obscure suburb, he predicted that the area would one day become "the centre of an immense and rich population". His museum now lies just 20 metres from the gleaming steel-and-glass towers of the European Parliament in Brussels (postal address: Rue Wiertz). When the parliament's members next pontificate about the need for state intervention, they should pop next door to Wiertz's studio, and have a ponder.

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Economist.com/blogs/charlemagne

## Regulating banks

# The devil's punchbowl

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**You thought that the party was over. Think again**

Illustration by David Simonds

A NEW hiring frenzy in the City, with bonuses guaranteed for “only” the first year; investment-banking results for the second quarter likely to top those of the first; an innovative securitisation by Barclays to get bank loans off its balance sheet. The term “business as usual” normally delights tradesmen and their customers. Applied to the banks that plunged Britain into economic crisis, it strikes fear to the heart.

Promised reforms to bank regulation, meant to curb the excess before it starts all over again, are in limbo. On July 8th Alistair Darling, the chancellor of the exchequer, unveiled plans to make banks hold progressively more capital, the bigger and more complex they are. Banks will be required, in effect, to add capital if they pose special risks to the system, including higher capital charges if they pay bonuses that encourage short-term risk-taking.

This all sounds plausible. But Mr Darling failed to explain how those varying capital requirements will be assessed and applied. In fact their calibration will depend not on Britain alone but also on work being done in Brussels for the European Council (a draft law is expected in October). And rules to increase the money banks must hold for liquidity are coming from the Basel Committee, a club of rich-country bank supervisors.

He also failed to change the outfit in charge of bank supervision. The much criticised “tripartite arrangements”, designed to help the Treasury, the Bank of England and the Financial Services Authority (FSA) act as one in a crisis, are hardly touched. The trio failed in its first big test, the collapse of Northern Rock in 2007, prompting calls for authority over banks to be concentrated in the Bank of England, as it was before Labour took power in 1997. Instead, Mr Darling wants the FSA to impose the varying capital charges; the Bank of England is to assess the systemic risk on which the charges will be based but will not have the power to enforce them. Overseeing it all will be a Council for Financial Stability, chaired by the chancellor himself.

Mr Darling’s long-awaited white paper sets out a blueprint of sorts for how the current regulatory system might be adapted to more perilous times. It ducks the big questions, however. In particular, a lively debate over whether risky “casino” investment banking should be split from “utility” commercial and retail banking, guaranteed by the taxpayer, has been cut short. The hope seems to be that, as their activities

demand more capital, riskier investment banking will be reduced or spun out of banking groups. More pressure to shrink may come from an insistence that banks demonstrate regularly how they would wind down their affairs in an orderly manner in the event of failure.

The European Union (EU) may also have a stick to wield, though it is not yet clear how big. On June 30th Neelie Kroes, the EU competition commissioner, declared that Royal Bank of Scotland (RBS), one of the two large banks the British government rescued and took a stake in, was too big, too complex and “highly dangerous to the European single market”. The EU has the power to demand the restructuring of a company that has received state aid. It has already done so with German banks.

Yet there is little sign that the government itself has the appetite or the will to confront such big banks head on, despite their huge size relative to GDP (see chart). UK Financial Investments (UKFI), the agency that runs the government’s stakes in rescued banks, seems interested only in preparing to sell them, not in getting the banks to serve the economy better. Moreover, its acquiescence in a £9.6m remuneration package for Stephen Hester, the chief executive of RBS, tied to the bank’s share price hardly discourages the resurgence of the old bonus culture. Exhortations by Paul Myners, the Treasury minister who oversees UKFI, to end short-term share-price targets ring hollow.


Indeed, the pay culture that rewards bank bosses for short-term risk-taking has barely been touched. Bonus pools, which in some firms scoop up as much as 50% of trading revenues, are a hangover from the days of private finance houses, when partners shared losses as well as gains. A draft review of corporate governance in banks is due on July 16th. It is chaired by Sir David Walker, a senior adviser to Morgan Stanley, an investment bank.

Understandably, the government is scared to risk further erosion of London’s position as a global financial centre. The earnings from financial services in a good year add over £25 billion to government revenues, and the financial sector employs over 1m people across the country. Against that is the loss in economic output from a full-scale financial crisis, which averages around 20% of GDP, according to an IMF working paper.

Adair Turner, the chairman of the FSA, expects no certainty on financial regulation until after the general election, to be held by next June. The opposition Conservatives, who are likely to form the next government, will produce their own white paper later this month. Apart from a promise by George Osborne, the shadow chancellor, to rip up the tripartite structure and give prudential supervision to the Bank of England, not much is likely to be proposed that would affect bank size, complexity or bonuses. Only Vince Cable, financial spokesman for the Liberal Democrats, argues for splitting up banks and making them lend more.

Stirring in the underbrush, however, is the Bank of England, which is beginning to provide the kind of analytical leadership that might have blunted the crisis had it come earlier. An analysis of the crunch by Andrew Haldane, the director for financial stability, has been described as “brilliant, but two years late”. More recently Paul Tucker, a deputy governor of the Bank of England, has spoken of a new “social contract” between banks and society, which would impose more realistic costs on banks for the taxpayer’s implicit guarantee. Why were those costs not priced in or even considered before? And, given the government’s fear of upsetting the City, are they likely to be priced in now?

Outsourcing torture

# Extraction

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**Did the government subcontract the removal of a man's fingernails?**

Greater Manchester Police

**Terrorist or no, Mr Ahmed needs his nails**

LIKE confessions teased out of a reluctant suspect, scraps of information about Britain's relationship with foreign torturers are gradually coming to light. The latest disclosures were made in the House of Commons on July 7th. David Davis, who resigned as shadow home secretary last year to become a one-man wrecking ball for the cause of civil liberty, accused the government of "outsourcing" the torture of Rangzieb Ahmed, a British citizen held in Pakistan for 13 months between 2006 and 2007.

Mr Ahmed is a self-confessed terrorist, supposedly once al-Qaeda's top man in Britain, who was given a life sentence by a British court last year for "directing terrorism". He says that during his time as a guest of Pakistan's security services he was beaten with staves and rubber tubing and had three fingernails prised off with pliers. During his stay he was asked questions which, the police accept, were drawn up with the help of mi5 and the Greater Manchester Police.

Even though he was a suspected terrorist under surveillance in Britain at the time, Mr Ahmed was allowed to travel to Pakistan. Mr Davis revealed that once Mr Ahmed had arrived in Pakistan, MI5 wrote to their Pakistani counterparts "suggesting" that they arrest and question him. Allowing him to go to Pakistan rather than charging him in Britain, and then getting the Pakistani services to ask him a list of questions using their well-known persuasive methods, amounts to "passive rendition", he said.

Claims of this sort are proliferating. In March a UN report said that Britain, along with America and Australia, had sent personnel to Pakistan to interview suspects who were being tortured. Even if the agents did not witness the abuse, their presence "can be reasonably understood as implicitly condoning such practices", it said. At least 15 people have claimed to have been tortured in various countries with the knowledge of the British authorities. Scotland Yard is investigating the case of Binyam Mohamed, a British resident arrested in Pakistan and moved between Morocco, Afghanistan and Guantánamo Bay. He says that he was tortured while being asked questions supplied by Britain.

That investigation may not come to much. Mr Davis points out that whereas America has owned up to its complicity in rendition but declined to prosecute junior officers, "we have done the opposite". The Mohamed investigation may claim only a few low-ranking scalps.

Mr Davis's performance in the Commons raises an interesting point. He made his speech there in order to benefit from parliamentary privilege. This prevents proceedings in the chamber from being used in court, and would therefore forestall prosecution under the Official Secrets Act of the whistle-blowers who gave information to Mr Davis. At the start of this month, the government proposed abolishing this immunity as part of its hasty bill to clean up Parliament after the MPs' expenses scandal. Those who voted it down cannot have expected to see themselves proven right so soon.

## Britain-baiting in Iran

# My Uncle Albion

Jul 9th 2009
From The Economist print edition

**The current ill will between the two countries has deep roots**

AS IRAN'S government moves to stifle criticism of its disputed elections, it is trying to pin the blame for the subsequent unrest on outsiders. To the bemusement of some in Britain—increasingly inclined to see itself as a third-rank power—the ayatollahs have fixed on perfidious Albion in particular. Relations between the two countries, often uneasy, have deteriorated. Britain responded to Iran's expulsion of two British diplomats by sending two of Iran's packing. Nine Iranian employees at the British embassy in Tehran were then arrested, on charges of inciting protests.

Eight have now been released but the ninth, the embassy's chief political analyst, is still being held, accused of undermining national security. The British government says the charges are baseless and the arrests unacceptable, but Iranian officials insist he must stand trial. Britain's Foreign Office, while treading carefully, is rallying its allies. At a press conference with Gordon Brown on July 6th Nicolas Sarkozy, France's president, assured the prime minister of his country's full support. The European Union condemned the arrests, and there were rumours this week that EU diplomats might be withdrawn.

Since the election Ayatollah Ali Khamenei, Iran's supreme leader, has singled out Britain as the "most evil" of those trying to interfere in his country's business. Britain, like America, strongly opposes Iran's nuclear plans and, unlike America, has an embassy in Tehran. Some think the Iranian government may consider Britain a less risky target than America. And there is a deep vein of anti-British sentiment to tap. Shouts of "Death to America!" may have echoed around Friday prayers in Tehran over the past 30 years, but the older imperial superpower has been a bogeyman in Iran for far longer.

The memory of Britain's two 20th-century invasions is bitter (Russia too invaded Persia twice, but it attracts less ire). Particular outrage is felt over Britain's role in the coup of 1953 which ousted Muhammad Mossadegh, an elected prime minister bent on nationalising the Anglo-Iranian Oil Company (a forerunner of BP). Though the CIA led the overthrow (in which MI6 was also involved), many Iranians suspect the British were really pulling the strings.

Tension has risen periodically since then. In the Iran-Iraq war of 1980-88, Iran reckoned that Britain backed Saddam Hussein. In 1989 Iran's supreme cleric, Ayatollah Ruhollah Khomeini, urged Muslims to kill Salman Rushdie, a British writer. Britain's hospitality to the People's Mujahedeen of Iran, an Iranian opposition group, is another irritant. In March 2007 Iran indulged in a spot of hostage-taking when it seized 15 British sailors. (After 12 days of Brit-baiting and dubious confessions by the sailors that they had trespassed into Iranian waters, the hostages were freed.)

Most recently the launch in January by the BBC of a Persian-language television channel has roused the ire of the Iranian regime. Whatever the BBC's claims to editorial independence, the authorities in Tehran have denounced the channel as "suspicious and illegal". Despite their best efforts to block it, it has proved popular in Iran, where satellite dishes are illegal and the state broadcaster dominates the airwaves. BBC Persian increased its time on air by five hours a day to 13 for four days after the election, further convincing some that it is a tool of the British government.

Iran's best-loved television serial, "My Uncle Napoleon", pokes fun at a man who sees the stealthy hand of British imperialism behind every event in Iranian history. The title is now used by Iranians to laugh at people who cling to this illusion. Those in government do not appear amused.

The agritainment business

# Hedge-fun managers

Jul 9th 2009 | DORRIDGE
From The Economist print edition

**From mazes to weddings, farmers are making more money out of the public**

Earlswood Maze

**Round and round the money goes**

NOT with a bang, but a moo, the last ever Royal Show closed on July 10th, ending a 170-year run. The agricultural jamboree, intended to spread innovation among farmers, could no longer meet its £300,000 ($480,000) costs. “Having 3,000 livestock for three nights’ bed and breakfast is expensive,” says Denis Chamberlain, the show’s marketing chief. Attendance has halved since the 1980s, mainly because the industry has consolidated into a small number of mega-farms rather than lots of minnows, he reports. It is a shame for non-professional visitors, whose attendance had held up relatively well.

The public now plays a big part in keeping farmers afloat. In Earlswood, down the road from the Royal Show in a quiet nook of Warwickshire, labourers are plucking avenues in a field to make a seven-acre “maize maze”, which all comers will be able to explore for £5 from July 18th, when the crop is high enough. The cost of designing the labyrinth, with the help of a GPS receiver and eight miles of string, will be outweighed by 15,000 or so visitors over the summer, hopes Steve Williams, the farm manager. And in October 80% of the crop will still be good to sell as cattle-feed. (This is a bonus in more ways than one: as long as the crop is sold, the maze doesn’t need planning permission.) The only threats are rain—and rabbits. “They like to have a chobble at it, but there should be enough left,” says Pete Smith, a maize-plucker.

Dozens of maize mazes have cropped up in recent years, including a 17-acre monster in Dorset that claimed to be the world’s biggest. One has even featured on “The Archers”, a BBC radio soap opera about the countryside. They are one feature of a growing “agritainment” sector: bed-and-breakfast accommodation, wedding venues and shooting ranges (both real and paintball) are among the ventures farmers have come up with to supplement their earnings. The Department for Environment, Food and Rural Affairs (DEFRA) reckons that a tenth of farms have diversified into sports and recreation activities. More still have exploited a fad for locally sourced food that has spawned scores of farmers’ markets (though the recession might drive people back to Tesco’s giant supermarkets). In all, diversified enterprises accounted for 15% of farming income in the financial year 2007-08, according to DEFRA, offering farmers a refuge from the turbulence in commodity prices that has buffeted them in recent years.

Prices have rallied lately; that, and difficulty in securing credit for new ventures, makes Phil Bicknell, an economic adviser at the National Farmers’ Union, suspect that farmers will focus more on their core business this year. Still, farms will still find it easy to branch out if they want to, as many own workers’ cottages emptied by the mechanisation of much farm work. These outbuildings are ideal for conversion into farm shops, shooting lodges or whatever might spin some money. One farm in Devon turned its old barn into a swingers’ club. Who says there is nothing to do in the countryside?

The politics of public-sector pay

# Missed opportunity

Jul 9th 2009
From The Economist print edition

**Politicians continue to shadow-box over the spending pain to come**

FOR a tantalising moment this week, it looked as if a grown-up debate might begin about how to tackle the public finances once a secure recovery is under way. It was too much to hope for. Instead of coming clean about the sacrifices that public-sector workers may have to make as part of efforts to reduce the budget deficit, politicians are ducking and weaving.

The door for such a debate swung open after Steve Bundred, chief executive of the Audit Commission, which monitors local public spending, spelt out some blunt truths. Mr Bundred said that cuts were coming after a general election next year whoever was in power. He suggested a freeze on public-sector pay as a "pain-free way of cutting public spending".

The Labour government and Conservative opposition quickly slammed the door shut on a proposition that had political pain written all over it. David Cameron took refuge in the review bodies, which set pay for about 40% of public employees, including such politically sensitive groups as nurses and teachers. The Tory leader's keenness on letting these handy outfits make the hard decisions was ironic on a day when he was announcing plans to prune some of the hundreds of quangos that have mushroomed in the interstices of the British state (see article).

The politicians may have dodged the hard ball Mr Bundred threw, but it will bounce back at them. The total bill for public-sector pay has risen by almost 30% in the past five years to reach £158 billion in 2008-09, worth a quarter of total spending. By dint of its sheer size, the public-sector pay bill will have to be curbed as part of a strategy to cut overall expenditure.

That will involve job cuts as well as pay restraint. For a long while the state has been outstripping the private sector in both employment and average earnings. The public payroll has recently jumped from 5.8m to 6m as official statisticians reclassified the Royal Bank of Scotland and Lloyds Banking Group to the state sector. But even before then it had climbed from 5.2m at the start of 2000. That 10% rise compares with a 6.5% increase in private employment over the same period.

Average earnings have also increased more for public staff than for private employees since the start of the decade. The gap has widened markedly in the past year as private earnings have been hurt by the recession and lower banking bonuses (see chart). The disparity is all the greater if pension rights are taken into account since public staff can still join generous defined-benefit schemes providing pensions linked to final salary and years of service. By contrast most private employers have closed these plans to new members because they are so expensive (see article).


Three-year wage deals that started in 2008 and cover many public workers were supposed to rein in pay. When they began trade-union leaders were miffed because the annual increases of around 2.5% looked unlikely to keep up with inflation, which surged last year. In fact the settlements were less harsh than they sounded because of "pay drift", whereby actual earnings rise faster as staff get paid more through promotions and the like; for nurses, for example, this averages an additional 1.5% a year. But now that retail prices are actually falling and wage freezes have become common in the private sector the maligned awards look rather a good bargain for public employees.

What this means is that eventual restraints on pay will have to be even greater as the Treasury tries to claw back its unintended generosity. This may be less painful than Britain's timid politicians fear. The starting-point will be salaries padded out by a decade of

decent growth. Moreover, the government does not spend its pay bill efficiently. It overpays staff in low-cost areas of the country like northern regions and underpays them in high-cost parts like London and the south-east. Nor is it obvious that public employers need to provide expensive final-salary pensions in order to recruit and retain staff.

The political neuralgia over public pay is understandable, since the parties are vying for the votes of state employees as well as private workers. But after so long a stretch when the public sector has done so well it is reasonable to expect some belt-tightening. After all, as Mr Bundred also pointed out, pay restraint is only one element in the spending curbs that will be needed. Both Labour and the Tories are doing the electorate a disservice through their lack of candour.

**Culling quangos**

# Ready for the chop?

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**Harsh words in public, but privately, politicians could not do without them**

Illustration by David Simonds


WHERE should the axe fall? The government and main opposition party are unanimous: on the "quasi-autonomous non-government organisations", or quangos, that carry out government functions, usually with government money, but at arm's length. On July 6th David Cameron, leader of the opposition Conservatives, promised that if his party came to power it would review the lot of them with an eye to a cull. Only those that provided essential technical expertise (like the Nuclear Installations Inspectorate), even-handedness (the research councils that dole out government money to universities) or transparency about government's functioning (the Office for National Statistics) would survive, he said. Perhaps to steal Mr Cameron's thunder, the Treasury had let it be known two days earlier that every government department had been asked to nominate quangos for the chop.

These agencies, authorities, commissions, panels, regulators and the like are easy targets. Some sound obscure (the Independent Reconfiguration Panel) or downright silly (Yorkshire Forward, Advantage West Midlands). Others look profligate: 68 pay their chief executives more than the prime minister's £198,000 a year. Seen *en masse*, they are shadowy and unaccountable: there are 524, or 790, or 827, or 1,164 of them, depending on whose definition you accept, spending between £34 billion (the government's figure) and £100 billion a year (according to the Taxpayers' Alliance, a lobbying group).

But the main reason quangos are under attack right now is that culling them seems to offer a way to tame public spending without hitting essential services. Sadly, savings are likely to be slim. Some particularly mockable quangos (the Potato Council) are funded by industry levies, not taxes. And the big money goes to those that allocate government cash rather than costing much themselves. Getting Whitehall departments instead to share out university funding, for example, might not save money: they are hardly strangers to the overmanning and empire-building that quangos are accused of.

And history suggests that quango culls are more for talking about than carrying out anyway. In opposition, both Margaret Thatcher and Gordon Brown promised a "bonfire of the quangos"—and yet both merrily set up more of them. That is because quangos are useful, for reasons that appeared nowhere on Mr Cameron's checklist. One is that they provide a way for politicians to look as if they are doing something. The Office for Fair Access was set up to monitor university admissions after a row about the scarcity of working-class youngsters at Oxbridge colleges. And when the problem, whatever it is, is yesterday's news, the quango remains, for fear that abolishing it would reanimate the issue, or provoke claims of heartlessness.

The main attraction of quangos, though, is that they allow politicians to duck tough decisions. It is the National Institute for Health and Clinical Excellence, not the government, that gets blamed when cancer sufferers are denied expensive drugs. And when Mr Cameron was asked whether he would freeze public-sector pay, he made use of the time-honoured evasion. "The way we do pay in this country in the public sector, rightly, is we have independent pay review bodies," he said. There are six of those, one each for the armed forces, prison staff, teachers, senior civil servants, doctors and dentists, and other health workers. Add in the two boards that rule on police pay and a dedicated consultancy, the Office of Manpower Economics, and that is nine quangos, at least, whose futures look secure.

The end of MG Rover

# A death revisited

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From The Economist print edition

**Was the carmaker the victim of a crime?**

PA


A LITTLE over four years after it collapsed controversially into the arms of the receiver, MG Rover, Britain's last indigenous volume carmaker, is in the news again. This week Lord Mandelson, the business secretary, announced that he had passed a long-awaited inspectors' report on the company's demise to the Serious Fraud Office. Lord Mandelson said that before the report could be published, the SFO had to determine whether there were grounds for a criminal prosecution against the so-called Phoenix Four, a group of four businessmen led by a former Rover chief executive, John Tower, who had bought the ailing firm from BMW in 2000 for £10.

Immediately, the opposition Conservatives and business journalists who had covered the affair smelt a rat. Among the questions asked were why the authors of the report, a forensic accountant and a senior barrister, had taken four years to complete it (at a cost to taxpayers of £16m) and why, if a crime was suspected, the SFO had not been called in much sooner. The widespread assumption was that Lord Mandelson was kicking the report into the "long grass" to avoid embarrassing disclosures in the run-up to a general election about the government's own role in Rover's failure. Denying any such intention, Lord Mandelson said that the SFO would complete its work within 20 days and he hoped publication would be possible "before too long". But if the SFO decides that there are possible grounds for prosecution, the expensively compiled report could remain out of bounds for some time.

Whether it contains much that is genuinely revelatory is another matter. The most important facts are well known. When BMW decided it wanted to dispose of its "English patient" after a financially disastrous six-year stewardship, it sold Land Rover to Ford for £1.8 billion, while keeping a factory in Cowley to build the New Mini. With the backing of the government and the trade unions, it gave the unattractive rump of the business to the Phoenix Four with a very soft loan of £427m and a tellingly large stock of unsold cars.

Although Mr Tower and his chums were greeted as heroes by the 9,000 workers at Longbridge (near Birmingham) for saving their jobs, nobody in the industry thought they had the remotest chance of building a sustainable business. Sub-scale, lumbered with dull, ageing models and lacking the engineering and financial resources to develop new products except in partnership with another car firm, Rover clearly had no future.

## A wasted dowry

That Mr Tower tried hard to find such a partner, eventually managing to tie up only a short-term asset-stripping deal with SAIC, a Chinese manufacturer, is not in doubt. The suspicion remains that the Phoenix Four realised quickly, perhaps from the outset, the hopelessness of the task, yet made certain through some nifty financial engineering that they would pocket a lot of money—over £40m, according to some estimates—whatever happened to Rover and the people who worked for it. It is now for the SFO to decide whether they were anything worse than greedy opportunists.

As for the British government, it was right to let Rover go to the wall when it did (the Phoenix Four claimed this week that Tony Blair had wanted to save it, but was overruled by Gordon Brown). It was wrong, however, to prefer Mr Tower's bid to an alternative one by Alchemy, a private-equity firm that would have whittled the company down to a small-scale sports-car manufacturer under the MG brand. The tragedy for thousands of Rover workers is that they lost the chance to use BMW's substantial dowry to fund far more generous redundancy terms than they got when the inevitable happened five years later.

**Bagehot**

# Pants on fire

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From The Economist print edition

**Politicians frequently lie. So does everyone else. Why all the fuss?**

Illustration by Steve O'Brien

THESE days Bagehot spends a lot of time pretending not to know there is a penguin in his wardrobe. It is his job to search for the penguin, while his toddler feigns ignorance about its whereabouts. Then she opens the wardrobe and triumphantly pulls out her toy. It is (naturally) very endearing. The game is also, if you stop to think about it, in the same cognitive family as lying.

Lying, as developmental psychologists have shown, is natural. It is an automatic, necessary, sometimes virtuous skill. For politicians it is—in a technical rather than pejorative sense—an essential one. These are eternal truths about falsehood. Yet, periodically, politics is dominated by lies. This seems to be one such time. The fixation of commentators and practitioners with them is telling, though not mainly about mendacity.

Sharp accusations of deceit have been levelled against Gordon Brown, by some Tories and assorted columnists. He stands accused of misrepresenting the fiscal plight that the victor of next year's general election will face, and Labour's ability to continue raising public spending. George Osborne, the shadow chancellor, attacked Labour's “big lie” and suggested Mr Brown had misled Parliament—a serious charge in Westminster's arcane code of propriety. Mr Osborne in turn has been said by Lord Mandelson to peddle “deliberate untruths”. David Cameron, the Tory leader, talked only slightly less rudely about a “thread of dishonesty” running through Mr Brown's premiership. Ed Balls, the ambitious children's secretary, has been drawn into the fracas too.

Mr Brown certainly has form when it comes to making incredible claims. Some see the barefaced insistence that black is white as an especial habit of left-wing politicians, of idealists committed and lapsed, who see little peccadillos as acceptable compromises on the road to their earthly paradise. In fact, dishonesty is unavoidable for almost all politicians.

Public obedience to party lines with which MPs privately disagree is one flagrant example. And when they loyally back leaders, deny aspirations to be one or resign to spend more time with their families, politicians fib. Mr Cameron (like Tony Blair) is good at seeming sincere; but as leader of the opposition he has been obliged to call incessantly for an election, sometimes when he can't really have wanted one. Then there are the paternalistic veils that all governments draw over aspects of their foreign-policy entanglements, some more justified than others. All that is before you delve into whether the standard

exaggerations, distortions and caricatures of political discourse properly count as lies.

That is not to say, as one corrosive view (reinforced by the expenses scandal) has it, that politicians are all degenerates: note the distinction above between technical and pejorative lying. In any case, politicians are only human, and humans lie all the time, if harmlessly and ritualistically. “Fine”, in answer to “How are you?” is often a lazy lie. People lie to spouses about their appearances (and other things), to children about Father Christmas and to themselves about their weight and drinking; in “The Wild Duck” Ibsen calls such salving self-deceptions “life lies”. Politicians have better excuses than most, being bound by commitments made in outdated manifestos and obliged to reconcile conflicting interests and withstand intrusive media scrutiny.

For all their cynicism, Britons are often willing to turn a blind eye—to let their politicians off, as Bagehot pretends not to know where the penguin is. (The violent row in Britain over Iraq’s non-existent weaponry is an obvious exception.) America gets more worked up about political obfuscation, perhaps because it has less restraining notions of courtesy, maybe out of a residual Puritan idea of the sanctity of language: books with alliterative titles such as “Lies and the Lying Liars” etc are current-affairs staples; rival candidates routinely accuse one another of dishonesty.

One of the life lies of British politics is that politicians are not liars. The striking development is not that the veracity of some is open to doubt, but that this forgivingly collusive arrangement has now broken down: not the fact of lying, but the naming of it.

## The life lie

One explanation, advanced by some Tories, is that Mr Brown has reneged on another implicit compact. Like other contact sports, the argument runs, politics can be brutal, but it still has rules, one of which is that arguments are conducted within agreed parameters. Treasury projections about the economy, for instance, must be believable and believed. The prime minister has violated these rules, making promises that can be defended only through leaps of faith about growth, inflation and tax receipts.

Another mooted reason for the name-calling is that the subject of Mr Brown’s alleged lies is too important for them to be countenanced: they must be exposed in order for the debt crisis to be addressed (and for the Tories to have the political space to be frank about cuts themselves). A third is simply that he has made the unfortunate mistake of making statements that can be easily contradicted. It is hard to prove what feelings lurk in the heart of an outwardly oleaginous MP. It is easy to compare ministerial braggadocio about spending with Treasury tables and the ominous sums done by the Institute of Fiscal Studies (though the fact that Mr Brown’s claims look implausible does not, in itself, make them lies: he may still really believe them).

There may be something to all of those explanations. But what is probably the most important one is uglier. It is that the approach of the election, combined with the poisonous mutual dislike of the two main parties’ leaderships, has (already) produced an unusually vicious and overheated political atmosphere. Some might regard the suspension of the usual hypocritical niceties as an admirable embrace of plain speaking. Others see it as coarse, undignified and liable to discredit the whole show.

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Faith, economics and ecology

# New sins, new virtues

Jul 9th 2009 | ISTANBUL AND ROME
From The Economist print edition

**As the world heats up and economic dislocation ravages the poor, religious leaders offer up their diagnoses and prescriptions**

PA

GLOBALISATION, technology and growth are in themselves neither positive or negative; they are whatever humanity makes of them. Summed up like that, the central message of a keenly awaited papal pronouncement on the social and economic woes of the world may sound like a statement of the obvious.

But despite some lapses into trendy jargon, *Caritas in Veritate* (Charity in Truth), a 144-page encyclical issued by Pope Benedict XVI on July 7th, is certainly not a banal or trivial document. It will delight some people, enrage others and occupy a prominent place among religious leaders' competing attempts to explain and address the problems of an overheated, overcrowded planet.

From photogenic Anglicans like Richard Chartres, the bishop of London (pictured with a Noah's Ark of young climate-change lobbyists), to the Dalai Lama, lots of prominent religious figures have been feeling the need to broaden their message. They are moving away from the old stress on individual failings (stealing, lying, cheating) and talking more about the fate of humanity as a whole.

But Pope Benedict, for all his concern with cosmic issues, is certainly not watering down his insistence on old-fashioned religious virtues, including caution and sobriety. On many big public questions, he proposes a middle course between faith in scientific progress and nostalgia for a simpler past. People cannot expect to avoid the extremes, Benedict rather provocatively adds, when they are looking at the world through purely secular spectacles. “When nature, including the human being, is viewed as the result of mere chance or evolutionary determinism, our sense of responsibility wanes,” he argues.

Displaying a better-than-usual sense of public relations, the Holy See released the document on the eve of a world leaders' summit in L'Aquila, east of Rome (see article). And like many other big pronouncements from moral leaders, it will be seen as staking out ground ahead of the Copenhagen conference on climate change in December.

Encyclicals are the heaviest ammunition in the papacy's intellectual arsenal. This one was delayed for more than two years as the Vatican's thinkers struggled to keep abreast of developments in the world economy. But the original purpose has remained intact: to offer a Catholic response to a global marketplace that in Benedict's elegant turn of phrase, “makes us neighbours but does not make us

brothers."

The document accepts the legitimacy of markets or profits, as long as they are not idolised, or elevated far above the human beings who are affected by economic decisions. But Benedict's proposal for discerning the difference between healthy markets and pathological ones is uncompromising and offers no sops to the secular. An economy, he suggests, is working well when it allows individuals and societies to fulfil themselves in every way—something that in his view can happen only when God is involved.

The encyclical grafts this ideal of development in the service of God and man onto an insistence on Catholic morality in ethics. As Austen Ivereigh, a British Catholic writer, puts it, "the message is that you can't believe in social justice if you also believe in abortion and euthanasia." Giving short shrift to non-believers, the pope also argues that without "truth" in the Christian sense, "there is no social conscience and responsibility, and social action ends up serving private interests and the logic of power." This purist approach may risk narrowing the scope for the sort of tactical co-operation between believers and secularists that is emerging on many fronts, from the fight against malaria to weaning the world off hydrocarbons.

Still, some non-Catholics may agree (and some Catholics may disagree) with one of the pope's more concrete proposals: an overhaul of global institutions—or in plainer language an expanded role for the United Nations or some other authority. The aim of this new structure would be "the management of globalisation". Vatican aides said this was not a proposal for world government—but it did sound a bit like that. Such a body would need to be universally recognised, subject to international law and "vested with the effective power to ensure security for all, regard for justice and respect for rights." Its areas of competence would include managing the global economy, disarmament, food security, the environment and migration. This may alarm those who see global bureaucracies' sloth, pride, envy, greed and gluttony (to name only a few deadly vices) as exemplars of human failing. But the Vatican's longing for a stronger UN goes back to 2003, when it was shocked by the world body's inability to stop the Iraq war.

## Do as you would be done by

In any case, Benedict finds the roots of the economic crisis in wickedness. The global recession, he argues, is merely the latest effect of a tendency to confuse happiness and salvation with prosperity. But economic activity "cannot solve all social problems through the simple application of commercial logic". And the market should not be a place "where the strong subdue the weak".

Throughout the document, leftish ideas about economics nestle alongside the austere moral reasoning that is a hallmark of the German-born pontiff. A conservative American Catholic, George Weigel, has claimed that only certain parts of it—the bits he liked—were written by Benedict; in other sections he detects the influence of the Pontifical Council for Justice and Peace, one of the more radical sections of the Vatican bureaucracy.

In the case of other religious leaders, the message is simpler. The Dalai Lama, for example, has drawn attention to a potential disaster which looms in his home region of Tibet: the melting of glaciers which serve as "Asia's water tower" by feeding the rivers on which billions of people depend. London's Bishop Chartres has spearheaded efforts to make England's established church much greener in its thinking and in its own behaviour. A plan called "Shrinking the Footprint" is intended to slash the carbon emissions of Anglican buildings, from cathedrals to vicarages to church halls.

AP

And in Istanbul this week, dozens of prominent Islamic scholars delved into their tradition for answers to environmental problems. Originating in a land where water is very scarce, the Muslim faith has much to say about the need to use resources in a just and cautious way.

Still, the idea of restraining carbon emissions is not an easy sell in countries that have grown rich from selling hydrocarbons and have enough cash to import water and food. Yusuf al-Qaradawi, a Qatar-based Islamic scholar and spiritual guide to the global Muslim Brotherhood, got a rave reception at the Istanbul meeting—but his speech focused more on matters of human hygiene than on the treatment of the natural world.

Another participant, the Grand Mufti of Egypt, is by comparison a trailblazer. Ali Gomaa has agreed to make the institution he heads—an office that issues fatwas, or rulings on ethical questions—carbon-neutral and is searching for carbon offsets in Egypt, a concept which few locals as yet understand. Islam's ecological message is much more readily grasped in the endangered forests of Indonesia and Malaysia. In Indonesia, for example, there are 17,000 madrassas—and a local NGO, the Conservation and Religion Initiative, reports good progress in persuading teachers in those schools to preach and practise good stewardship. As a follow-up to the Istanbul gathering, Muslims and adherents of many other faiths will meet in Britain in November and present plans for greener management of their resources.

**A deeper shade of green: Ali Gomaa**

While Muslim greybeards deliberated, two leading figures in the eastern Christian world—the Ecumenical Patriarch, Bartholomew I, and the newly enthroned Patriarch Kyrill of Moscow—held a joint service nearby that signalled a warming in their relations and a common commitment to cool and generally improve the world. Patriarch Bartholomew, who is planning to host an eco-symposium in New Orleans in October, called for an investigation of the "deeper spiritual and moral causes" of the planet's woes. Residing as he does near a narrow strait plied by giant tankers which bring oil from the Black Sea to the Mediterranean, the Istanbul-based "green patriarch" was far ahead of the Vatican in calling pollution a sin.

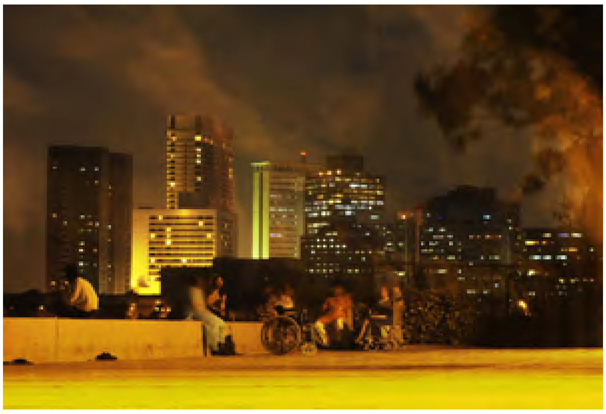
Climate change talks

# Wanted: fresh air

Jul 9th 2009
From The Economist print edition

**Poor countries wrangle with rich ones about who can burn what and when**

Panos



**In India, too, some consumption is conspicuous**

WHEN argument fails, try metaphor. Shyam Saran, who heads India's international negotiating team on climate change, says that greenhouse gases are taking up "carbon space" in the atmosphere. Past emissions of carbon dioxide and other gases from rich countries have taken up much of that space. Now the poor countries are standing up for their right to a little bit of that space too.

Put in those terms, it seems a matter of plain justice. Mr Saran is merely defending India's right to industrialise. But as a negotiating position, it is one of the reasons why the talks on climate change at the G8 meeting in Italy this week have proved so fractious. Mr Saran says that the only limit India will accept on greenhouse-gas emissions is the same per-person amount enjoyed by citizens of developed countries. From the planet's point of view that would mean a huge, and possibly catastrophic, increase in overall emissions.

India's tough approach is supported by other developing countries. China, now the world's biggest greenhouse-gas emitter, is particularly annoyed about a provision in America's new cap-and-trade legislation on carbon emissions that would let America impose tariffs on goods from countries that do nothing to control emissions. The bill's drafters reckon that China and similarly energy-thirsty countries are in effect subsidising their exports by allowing their firms to dodge costly environmental standards. But the Chinese say the measure could lead to a trade war.

Brazil takes a similar position. The cutting down of trees in the Amazon alone releases 700m tonnes of carbon dioxide into the air annually, fully half of the country's total emissions. Brazil says it wants to curb deforestation, but it is reluctant to let outsiders' rules tie its hands on the management of its sovereign territory.

The rich countries think they have already done a lot to meet the poor world halfway. At the G8 meeting in L'Aquila they proposed a "vision" in which the industrialised countries would by mid-century cut their emissions by 80% (against which base year is unclear), as part of a global effort to reduce emissions by half. The developing countries could burn more carbon as they got richer, but far less than the rich countries did in the 20th century. If the sums are correct, this would cap the rise in average global temperatures at 2°C (though that may still cause a lot of harm). If the poor countries do nothing, the rich countries argue, their own expensive efforts will be in vain. But with no interim targets, by mid-week the "vision" was fading from the draft deal at the summit.

This failure threatens to unravel a flimsy diplomatic consensus that dates back to the 1997 Kyoto

protocol. Signed by most rich countries, this spoke of "common but differentiated" responsibilities for cutting emissions. This was diplomatic language that required nothing binding of developing countries and was the main reason why America never signed up for Kyoto. Barack Obama's green-minded administration has changed that. So the spotlight is now on the poor countries. Their past position, of denouncing the previous American administration for inaction and hypocrisy, was enjoyable while it lasted but looks flimsy now. Instead they are being pressed to explain what if anything they are willing to do to save the planet.

The rich-world coalition is getting rickety too. America's new seriousness turns unwelcome attention on countries such as Canada, Japan and Australia. They are seen as having fallen behind by the Europeans, the leaders (relatively speaking) in clean green growth

A dose of Mr Obama's eloquence may bring a breakthrough by the end of the week. But the departure of the Chinese leader, Hu Jintao, to deal with unrest at home, seemed set to jinx the meeting's chances. If the L'Aquila summit fails, the deadlock will threaten the climate summit to be held in Copenhagen in December. Governments' efforts to deal with what many voters see as the world's biggest problem will look pretty feeble.

Fresh thinking, instead of stale arguments, has rarely been so badly needed. A new paper published in the *Proceedings of the National Academy of Sciences* this week offered a contribution, based on the idea that it is rich people, rather than rich countries, who need to change the most. The authors suggest setting a cap on total emissions, and then converting that cap into a global per-person limit. This would be low enough that if everyone stuck to it, the worldwide target would be met.

Each country would then have the task of reducing its national consumption according to its number of "high emitters"—people with an extravagant output of carbon. Such individuals are scarce in India, more common in China, and common in America. If the goal were to cap emissions at 30 billion tonnes in 2030, say, that would mean squeezing the behaviour of some 1.1 billion "high emitters" worldwide. So the high-living, carbon-guzzling rich minority in India and China would not be able to hide behind their poor and carbon-thrifty compatriots.

The paper suggests that the personal emissions target would be set at around 10.8 tonnes of CO2 per year. China would have 300m emitters over this level by 2030, meaning that the country's 4 billion tonnes of carbon emissions in 2003 should rise to no more than 8.5 billion in 2030, as opposed to a predicted 11.4 billion if China does nothing. The cuts required in Brazil and India would be far smaller, as they have fewer rich people. America's cuts would have to be greater than those in the administration's cap-and-trade bill.

It sounds a rather elegant idea—if implausibly complex to carry out. But as a thought experiment, it shows how even Mr Saran's definition of "fair" falls short of the mark.

A cyber-warfare mystery

# Ghost in the machine

Jul 9th 2009
From The Economist print edition

**When is a cyber-attack a real one?**

AMERICA and other countries still have to fine-tune their cyber-defences to distinguish mere nuisances from real menaces. That, rather than any revelations about fiendish North Korean cyber-warfare, seems to be the upshot of the latest reported cyber-attack on South Korean and American websites.

Initially, it was reported that this was the first series of attacks to hit government websites in several countries simultaneously. Officials in both Seoul and Washington, DC, said they were suffering "distributed denial of service" overload (known as DDOS in geekspeak). In these a computer is overwhelmed with bogus requests for a response sent from infected computers. American targets included sites at the Treasury, the Secret Service, and the Transportation Department; the South Korean list included the Defence Ministry, the National Assembly, the presidential Blue House and some banks. The timing felt eerie: attacks began on July 4th, Independence Day.

Neither country is a stranger to cyberwarfare. The South Korean Defence Security Command reported an average of 95,000 daily attacks. Some security experts blame North Korea, which has supposedly trained an elite group of hackers at Mirim College, its military school. In a speech in May, President Barack Obama called cyber-security one of America's "most serious economic and national security challenges."

Yet little hard evidence has emerged about the seriousness of the attacks or their origin. Plenty of people may wish to spoil America's national holiday. According to Arbor Networks, a security firm, the attack was "comparatively small scale". Setting up an attack takes a competent cyber-hooligan five minutes' work on a laptop. It is not just the bad guys who can do it: Iranian government sites have been attacked during the country's recent unrest. A popular post on Twitter, a social networking site, was "#Iranelection Cyberwar Guide for Beginners", highlighting a site compiled by a sympathetic Welsh civil servant.

# Lone Star rising

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From The Economist print edition

**Thanks to low taxes and light regulation, Texas is booming. But demography will bring profound changes, says Christopher Lockwood (interviewed here)**

Corbis

VISITORS to Governor Rick Perry's vast office in the Texas capitol building in Austin (with a dome a mite taller, naturally, than the one in Washington, DC) are sometimes offered a viewing of a triumphalist video. Entitled "The Texaplex", the seven-minute film is a hymn to the successes Texas has achieved in recent years, and they look pretty impressive.

Texas now hosts more *Fortune* 500 companies than any other American state. They include AT&T, Dell and Texas Instruments; oil giants such as Exxon Mobil, ConocoPhillips and Valero; American, Continental and Southwest Airlines; Fluor, a huge construction firm (recently lured from California); J.C. Penney; Halliburton; and 52 others. Texas claims to have been responsible for 70% of all the net new jobs created last year in America's 50 states, though since only a few states created any jobs at all that is not quite as astonishing as it sounds.

True, the film tactfully ignores the recession. Texas followed America into the downturn in September last year, almost a year after the rest. In May it shed a worrying 24,700 jobs, and the Dallas Federal Reserve now forecasts that between 315,000 and 350,000 jobs will go in 2009. But proportionately the May figure was still lower than for the nation as a whole, and Texas's unemployment rate, at 7.1%, was 2.3 points below the American average. Housing repossessions are still very rare; the state budget is still in surplus even as California and New York teeter on the edge of bankruptcy. Unlike those fellow states with large populations, Texas levies no personal income tax, and with almost unlimited space on which to build, its houses are big and affordable.

All this has brought people flooding in and made Texas America's fastest-growing state. Net domestic inflows have been running at around 150,000 people in recent years, whereas California and New York have seen net outflows. Next year's national census is expected to show that flourishing Houston has replaced struggling Chicago as America's third city. Of the ten largest cities in America, three are in Texas.

Those three, Houston, Dallas and San Antonio, together with the state capital, Austin, and Fort Worth, make up what the boosters call the Texaplex: a densely packed triangle, with each side measuring about

300 miles, that is home to roughly 80% of the state's population of 24m (second only to California's 37m). This "Texas triangle", containing America's third-largest airport (Dallas-Fort Worth) and its second-busiest port (Houston, despite being 50 miles inland), has emerged as one of the most dynamic regions in all of America.

Joel Kotkin, an urbanologist based in California, recently compiled a list for *Forbes* magazine of the best cities for job creation over the past decade. Among those with more than 450,000 jobs, the top five spots went to the five main Texaplex cities—and the winner of the small-cities category was Odessa, Texas. A study by the Brookings Institution in June came up with very similar results. Mr Kotkin particularly admires Houston, which he calls a perfect example of an "opportunity city"—a place with lots of jobs, lots of cheap housing and a welcoming attitude to newcomers.

He is certainly right about the last point: not too many other cities could have absorbed 100,000 refugees, bigheartedly and fairly painlessly, as Houston did after Hurricane Katrina struck New Orleans. With vibrant Asian communities alongside its balanced Hispanic, white and black mix, with no discernible racial tensions, and with more foreign consulates than any American city except New York and Los Angeles, Houston is arguably America's most enthusiastically cosmopolitan city, a place where the future has already arrived.


Wander round to the Senate side of the state capitol, though, and you will hear a different Texan tale. There, you might encounter Eliot Shapleigh, the Democratic state senator for a district centred on El Paso, on the extreme west of the Mexican border. Mr Shapleigh publishes his own report: "Texas on the Brink".

His statistics are a lot less rosy. Texas has the highest proportion of people lacking health insurance of all 50 states; the third-highest poverty rate; the second-highest imprisonment rate; the highest teenage-birth rate; the lowest voter turnout; and the lowest proportion of high-school graduates. Mr Shapleigh is not surprised that these figures are so terrible: Texas spends less on each of its citizens than does any other state. Being a low-tax, low-spend state has not made Texans rich, though they are not dirt-poor either; their median income ranks 37th among the 50 states.

These two faces of Texas are hardly a paradox. Texas has one of the most unequal income distributions of any state, a legacy of the days when rich ranch-owners and oil billionaires were served by poorly paid ranch hands and roughnecks; and when Mexican immigrants crossed an essentially open border at will to toil away at sun-scorched farm jobs for pay that "Anglo" (non-Hispanic white) workers would not contemplate. You might call this Texas's persistent "Southern" side, a contrast to its high-tech, urban

and liberal “Western” side. These two aspects of Texas’s character and history still sit uneasily together, just as geographically the vast landmass of Texas belongs both to the South and the West.

Historically, a low-tax, low-spend model has served Texas fairly well, though the limitations of dependence on a few commodities (oil, cattle, cotton) were cruelly shown up in the mid-1980s. When the oil price crashed, the property market and then the entire banking system went down with it. Between 1982 and 1993 Texas saw 523 banks go under, and in the single year of 1986 its gross state product slumped by 3.1%. Since then it has been diversifying frantically, with considerable success.

## Starstruck

But there are now two big reasons to think that the Texas model will need further revision. One is external to the state: the global economy has become a much more knowledge-intensive place, with even the oil business turning into a high-tech industry, so Texas needs more and better universities and schools. Embarrassingly for the state, only one of its universities (the small, private Rice University in Houston) makes it into the list of the top 20 universities in America, let alone the world.

In contrast to those *Forbes* ratings, the Kauffman Foundation, which promotes entrepreneurship, puts Texas only 18th in its ranking of states’ ability to take advantage of America’s “transformation into a global, entrepreneurial and knowledge- and innovation-based New Economy”. Texas falls down in a number of categories, most of them to do with education.

Kauffman ranks Texas 41st for the education level of its workforce as well as for the average education level of recent arrivals from elsewhere in America, suggesting that too many of its newcomers are chasing low-end jobs. A committee on education appointed by Mr Perry concluded in January that “Texas is not globally competitive” and gave warning that it “faces a downward spiral in both quality of life and economic competitiveness”.

The other, even more important, reason to expect change is internal. In 2004 Texas became one of only four states in America where whites are no longer in the majority. On recent trends, Hispanics will be the largest ethnic group in the state by 2015. Since they tend to vote Democratic, this has big implications for Texas’s political make-up and for national politics. And an increasingly assertive Hispanic caucus, in an increasingly Democratic state, also seems sure to demand better schools and health care for the people it represents, who currently lag far behind the Anglos on any social indicator you care to name. Close to half of Latinos in Houston, for instance, fail to graduate from high school.

How Texas responds to these forces will determine its future. Get it right, and the state will remain business-friendly and globally competitive, with high employment and a rising standard of living. Get it wrong, and Texas could follow California (which “flipped” from Republican to Democratic control in part thanks to rapid immigration) down the road of high taxes and excessive regulation. This route has bankrupted California and is prompting a net 100,000 people to leave each year. Many of them head for Texas. One simple statistic tells that tale: it costs nearly three times as much to rent a self-drive van for a one-way journey from Los Angeles to Houston as the other way around.

# Tex-mix

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**The state's best and worst sides**

THOUGH the Texas model has many critics, its admirers tend to list the same advantages. The low tax burden (second-lowest in America) invariably comes top of the list. Arthur Laffer, inventor of the famous curve, reckons that one of the most important determinants of whether a state does well or badly is not just the overall level of taxes but their structure too. A high, progressive personal income tax, he says, is about the worst incentive-killer you could devise. Americans are highly mobile, so the most able will simply leave for another state. Mr Laffer himself left California for low-tax Tennessee three years ago because he felt that bad taxes were destroying the state's economy.

Progressive taxes are considered fairer, but better to leave it to the federal authorities to impose a progressive income tax, the same for every state. The nine states with a personal-income-tax rate of zero, Mr Laffer finds, had net domestic immigration of 4.5% of their population in the ten years to 2007; the nine with the highest marginal tax rates saw outflows averaging 2.2%. A high state tax on capital gains is also bad because it tends to be volatile, causing big budgetary problems. Texas does not have one of those either.

Next on its list of advantages usually comes the feeble state of its unions. Texas, like 21 others, mostly in the South, is a "right to work" state, so no one can be compelled to join a trade union. Only 4.5% of its workforce is unionised, against 12.4% nationally. Even where unions are well represented, as at the port of Houston, the management says they behave sensibly.

Then there is tort reform. Texas used to be a plaintiff's dream, with few restrictions on who could sue for what and where. Class-action suits against big corporations used to be heard by juries who made free with the defendants' money. George Bush (who was governor of Texas from 1995 until he headed off to greater things in 2000) partially reformed the system in 1995. Rick Perry, his successor, oversaw a second reform in 2003, concentrating on medical awards that were driving doctors away. Since then malpractice-insurance rates have fallen and the doctors have returned.

The state's sound public finances are often noted too: in the landmark legislative session of 2003 (Texas's legislature meets only every other year, for 140 days) Texas eliminated a budget deficit of close to $10 billion and has not looked back. It is still in surplus, though only thanks to a large dollop of cash from the federal government. Since 1988 the state has maintained a "rainy-day fund", paid for by taxes on oil and gas companies, which is now worth $6.7 billion; it can be raided only if two-thirds of both houses of the state legislature agree, and Mr Perry vows not to touch it in the current, arguably rainy, downturn.


A fourth factor is the amount of help that state and local government offers to business. Here purists on

the right find common ground with those on the left who complain that companies are given generous tax breaks but education and health are underfunded. All states these days compete to get businesses to move in; Scott McCown of the Centre for Public Policy Priorities (CPPP) in Austin calls this "buying dates". Such incentives distort the market and benefit newcomers at the expense of established companies.

Texas's package of benefits is handsome. In 2003 its legislature voted in a Texas Enterprise Fund, with $295m, since topped up, to spend on luring companies to Texas; that was followed two years later by a $235m Emerging Technology Fund. These are among the biggest such funds anywhere in America.

The legislature also allows Texas city governments great latitude in designing their own inducements for business. Free land, cheap electricity, subsidies towards the wages of higher-paid workers, funds for training and long tax holidays are now essential weapons in municipal armouries. Most controversial are the "abatements" offered to big investors that exempt them from paying property taxes to the local school districts; in Texas, as in most states, these taxes are the schools' main source of funding.

## Sprats and mackerels

Such inducements are helpful for the companies, but they also make business sense for the cities that offer them. Gary Lawrence, who heads the Economic Development Alliance of the city of Lubbock, in the Texas panhandle, explains that one electronics investment he backed cost the city $4.7m in revenue forgone over ten years. But in return the company undertook to create 165 well-paid jobs, creating a demand for houses that is increasing income from property taxes as well as sales taxes. The $4.7m should be written off in as little as three years. This kind of deal has put Lubbock on the map.

Mr Perry and the Republicans who have dominated both chambers of the legislature since 2003 can claim some credit for all those boosts to business. But they get none for Texas's biggest advantage: its sheer size. Larger in area than any country in the European Union and than any American state bar Alaska, Texas has huge amounts of space into which its cities can expand. This has allowed Houston to sprawl over some 600 square miles; it is probably the most spread-out big city in America and has no zoning restrictions, allowing the market to determine the best balance between retail, commercial and residential uses.

California is constrained by its mountains and the ocean, to say nothing of the demands of environmentalists keen to preserve its remarkable natural beauty. Texas, says Michael Lind, a fifth-generation Texan who writes about demography, identity, history and much else, "is flat and ugly. The Sierra Club is not going to kick up a fuss if Houston or Dallas keeps on growing." He is being a little harsh; most of central Texas is perfectly nice-looking grassland. But there certainly is a lot of it.

Limitless space translates into low property prices; you can buy a 1,500 square foot (140 square metre) starter home for as little as $100,000 in a decent part of Houston or Dallas; small rented homes in the grimmer parts of south-east Houston are advertised for as little as $99 a week. With taxes and prices also lower, an incomer from California might easily save 30% or more of his salary by moving from Silicon Valley to the "Silicon Hills" of Austin.

## Learning difficulties

Red McCombs is no bleeding-heart liberal. A lumbering giant of a man and one of Texas's crop of a couple of dozen billionaires, he built his fortune by buying and selling everything from car dealerships to football teams. But he gets distinctly emotional about the poor performance of Texas's educational system. "The biggest blight on our state", he thunders, "is the terrible graduation rate from our high schools. Shame on us! It's been that way for 30 years, and it's getting worse. Have we been greedy, ignorant, uncaring? Maybe all of those things."

Mr McCombs is not alone. Almost everyone interviewed for this report expressed concern about the poor state of Texas's public schools and the mediocre record of its universities. Stephen Klineberg, professor of sociology at Rice University in Houston, puts it bleakly: "If we fail to turn our education system around, we will find that a whole generation has been locked out of the jobs market." The drop-out rate from Texas's schools is high across all three of the main racial groups, white, black and Hispanic, but it is the Hispanic drop-out rate that worries people most.

According to Mr McCown of the CPPP, the only answer is more taxation. “We advocate a state income tax,” he says, “and the emerging majority’s need for better education and health services will eventually produce one. The problem is that if we wait until then, we will lose a generation getting there.” Texas ranks 34th in terms of expenditure per pupil, but Mr McCown reckons that it needs to spend more than the average, not less, because of the high proportion of its students that do not speak English at home, or at all.

Others disagree. If money were everything, California’s children would have much better test scores than Texas’s, but a recent study by McKinsey, a consultancy, shows the opposite. As it happens, Houston is the birthplace of two independent or “charter” school movements that are now taking America by storm: KIPP (the Knowledge Is Power Programme—see box, previous page) and YES (Youth Engaged in Service).

Neither requires increased spending; in fact, their costs per pupil are generally lower than those of the school districts in which they operate and compete. Their results have been phenomenal, with typical drop-out rates of less than 5%. But the number of charter schools in Texas is currently capped at 215, and a mere eight new ones were authorised last year. And only well-motivated parents tend to send their children there. However, there is some evidence that their presence is encouraging the school districts to up their game.

For Texas’s universities, there is probably no substitute for digging deep and spending more money, and the state government is trying to do just that. Embarrassingly, Texas has only three “tier-one” universities (generally defined as meaning that a university undertakes at least $100m-worth of research a year). California has nine tier-one universities and New York state seven.

## Buying brainpower

Texas’s three are the University of Texas at Austin; A&M at the small town of College Station; and the tiny (and private, hence expensive) Rice at Houston. So none of Texas’s three largest cities has a big tier-one university to its name. A bill passed by this year’s legislative session commits the state to help no fewer than seven tier-two universities reach tier-one status. If voters agree in a referendum, up to $680m could be available. Texas should also be saving money by cutting administrative costs at the universities, which are way too high.

Other efforts are under way. Francisco Cigarroa, the chancellor of the University of Texas system and the first Hispanic ever to hold this prestigious job, says his board has authorised a $150m fund to bring leading academics to Texas. The system, made up of 15 centres of learning, now has a $3 billion fund (approved in a 2007 referendum that would surely have failed in just about any other state) to establish a world-class cancer foundation. It has just recruited a Nobel laureate as its chief scientist.

David Dewhurst, Texas’s lieutenant-governor and president of the Senate (jobs that arguably make him the most powerful person in the state), says that Texas is still adding to its university enrolment whereas California’s is contracting. “If you aren’t making money, you can’t expand,” he says. That, in a nutshell, is the philosophy of Texas today. But allowing the state’s schools and universities to improve enough to meet its future needs, while keeping the low taxes that businesses find so attractive, will be a tricky balancing act.

# Work hard. Be nice

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### A new breed of school for some of the poorest kids

KIPP Academy

And play hard too

A CHEERY yellow building in south-west Houston may not look like the centre of an educational revolution, but appearances can be deceptive. Bedecked with upbeat slogans—"People make the difference", "Think like a champion today", "Be the constant, not the variable"—the building houses the main offices and assembly area of the KIPP Academy, Houston, the first of a network of 66 schools in 19 states and Washington, DC.

KIPP (Knowledge Is Power Programme) started in 1994 with a simple philosophy, encapsulated in its main motto, "Work hard. Be nice." It stresses personal responsibility and hard work (even the youngest students can expect a couple of hours of homework a night, and teachers must be available on their mobile phones to help with it) and tells its pupils that "there are no short cuts."

The KIPP schools are the most striking example of a movement that is improving education across America: the rise of "charter" schools. These are paid for by state governments and free for the students, open to anyone and, crucially, independent of often badly-run school boards. Head teachers have wide discretion in the hiring and firing of teachers and are free to pay by results as they think fit. Charter schools are a mixed bag, but the best of them are achieving results most board-run schools can only dream of and are heavily oversubscribed.

Central to the KIPP programme is the contract that all students (or KIPPsters) sign before they join the school, which commits pupils, parents and teachers to do everything in their power to ensure that the pupils complete their courses and go on to a university. Critics say that this, in effect, excludes children from the most deprived families of all.

Still, around 70% of the academy's students come from low-income families, and around 95% are either Hispanic or African-American. Typically, says Elliott Witney, the head of the academy, only about 7% of students from low-income families graduate from college; KIPP's rate so far has been over 90%, though it has not yet quite achieved its goal of 98.6% ("body temperature").

KIPP's successes may be due to exceptional leadership, but according to Mr Witney there is no reason to think that they cannot be widely replicated. The rapid expansion of KIPP schools across the country is proof of that, and Mr Witney says these days there is no shortage of highly motivated young people who want to work as teachers in such schools. KIPP can hardly be the answer to all of Texas's problems, let alone America's. But along with the five campuses operated by YES (Youth Engaged in Service), with a very similar philosophy, it is an important part of it.

Economist.com SPECIAL REPORTS

# Beyond oil

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**The Texan economy is becoming ever more diversified, but energy remains a favourite**

HIGHWAY 84, as it descends from Lubbock through Snyder to the small town of Sweetwater, is a road worth taking. Spread across the vast plain are thousands of windmills, gently turning in a favourable wind; not too slow, not too fast and, above all, fairly consistent.

Only as you draw near to one do you realise that these towers are the height of 40-storey buildings; their blades are the length of a jumbo jet's wing. They are clever too. Without human intervention, they can turn their heads and alter the pitch of their blades to make the most of the wind. They cost about $5m apiece.

Sweetwater calls itself the windpower capital of America, and with roughly 3,300MW of installed capacity within a 50-mile (80km) radius the claim is not extravagant. Already endowed with oil and gas, Texas is blessed with a fair wind as well. Even stronger and more consistent winds are to be found further north along the "wind corridor" that stretches from the west Texas plains up through the panhandle and into Oklahoma and beyond. But for now these areas are too remote to be connected to any of America's three main grids: the eastern, the western and Texas's very own ERCOT grid.

Another five transmission lines to ERCOT are therefore being built. Texas has already exceeded threefold a target it set itself in 1999 for the amount of power to be generated from renewables, almost wholly thanks to wind. And much more is planned: T. Boone Pickens, a famous local corporate buccaneer, plans eventually to install 4,000MW-worth of windmills in the panhandle, and to build his own transmission line to the main grid.

Wind is inherently variable, so it can never compete with the cheap and dirty coal that generates half of America's electricity. But powering up a coal station takes half a day, so electricity companies get their baseload from coal or nuclear sources and rely on something else to handle variations in demand. Most use natural gas; the latest gas generators can power up or down in five minutes. Wind makes an excellent substitute for some of that gas, and some of the most interesting "power plays" in Texas involve a mix of the two. John Crew, manager of Republic Power Holdings in Dallas, says he is aiming to provide 6,000MW through a mixture of gas, wind and clean coal up in the panhandle.

Lucky Texas has abundant natural gas, too. Though it has seen no significant onshore oil finds for decades, it has done well with gas in the past few years. This is a matter of technology as much as geology. Since the turn of the millennium engineers have perfected the art of drilling horizontally through hard shale. One main vertical shaft can now branch out into as many as a dozen "legs", each perhaps 5,000 feet (about 1,500 metres) long; all this at depths of 8,000-13,000 feet.

As well as saving money, this makes it possible to extract gas from below urban areas—and, as with the lucrative Barnett shale, from under the Dallas-Fort Worth airport. East Texas also saw extensive provings in 2008. The Haynesville shale, which extends into Louisiana, is a huge find.

The search is now on for alternative uses for the fuel. The obvious one is to power vehicles with compressed natural gas (CNG). That would mean creating a network of filling stations for private users, but public transport and some other commercial users could operate their own, and since CNG is much cheaper than petrol they could save money.

The environmentalists' holy grail is "clean coal" which does not produce greenhouse gases. That means capturing and sequestering the carbon dioxide released when the stuff is burned. With present technologies that is uneconomic. But what if there is a market for the CO2?

The easily available oil from West Texas's Permian Basin, the richest oilfield in America, is mostly gone now. The best way to extract the remainder is to pump gas down to force the oil out. Oil companies use CO2; once pumped down, it is trapped there. It may be economic to establish a clean-coal plant in or

near the Permian Basin, trucking in the coal from Wyoming and selling the $CO_2$ to nearby oil operators. Several firms are now pursuing this idea in and around the oil town of Odessa.

## Multi-trick pony

But hydrocarbons these days are only a small part of what drives Texas's resilient economy. Work by the Dallas Federal Reserve suggests that the economy's sensitivity to changes in the oil price has diminished to only one-sixth its level in the 1970s and 1980s. That helps to explain the relatively muted impact on the state of the oil-price crash at the end of last year.

A 2004 paper by Robert Gilmer, an economist with the Dallas Fed, has an interesting take on some of the forces that have helped Texas diversify. He argues that the four main cities of the Texas triangle should be seen as a vast single economic entity, separated only for geographical and historical reasons and complementing rather than competing with each other.

Thus, San Antonio handles trade with Mexico, which has been a huge boon to Texas since the creation of the North American Free-Trade Agreement in 1994: Texas has been America's biggest exporting state every year since 2002. Toyota's decision in 2003 to put a huge new factory and supplier park there had a lot to do with the Latin American market.

The Dallas metroplex is strong in telecoms, aerospace, distribution (four interstate highways converge there) and banking. Houston has oil and gas, but also NASA and the Texas Medical Centre, an agglomeration of 47 not-for-profit hospitals, medical schools and other institutions. Austin, as well as housing the machinery of state government, has developed into a thriving high-tech cluster. Inevitably there is overlap, and conflict; San Antonio has not forgiven Dallas for luring AT&T away last year. But Mr Gilmer argues that the cities are not so much rivals as partners.

Redferns

**Austin's weird and wonderful side**

A few conclusions can be drawn from all this. First, the role of government, at all levels from federal to local, has been surprisingly strong for a state that likes to think it typifies rugged individualism. The decision to put Mission Control in Houston back in 1961 kick-started that city's non-oil economy. San Antonio has boomed thanks to the presence of three large military bases, and the well-managed closure of a fourth in 2001 has created a vast new air- and rail-distribution port, mainly serving Mexico. Much of Dallas's electronics industry began with defence contracts.

The University of Texas at Austin, one of America's largest single campuses, has helped that city become a leading high-tech centre. Dell, one of America's 40 biggest companies, started life at the university in 1984, and smart industrial policy brought Sematech, a consortium involving the government as well as 14 big chip firms, to Austin in 1988. Scores of other tech firms have followed.

Second, Texas has benefited from transplants. Cheap property and low taxes have attracted corporate headquarters and start-ups alike. At a round-table organised for *The Economist* in Austin by Angelou Economics, a consultancy that specialises in matching "new economy" businesses with cities that want them, only two of the 12 entrepreneurs taking part were native Texans. Most of them cited non-economic as well as commercial reasons for being in Austin. "Quality of place" is a phrase you hear a lot in Texas.

The Greater Houston Partnership, an alliance of hard-nosed businessmen that looms large locally, has worked well with Bill White, Houston's business-minded but green mayor, to support his clean-up of the city's air and water. Dallas, fearful of being outdone by Houston's top-notch Wortham arts centre, will soon have a spanking new opera house and a big theatre complex. The opera house was paid for by 300 families, each ponying up $1m. A big part of Austin's draw is its music, and particularly its SXSW festival. Austin is a remarkably laid-back place, with all the advantages of being a blue city in a red state.

Third, geography counts for a lot. Texas's importance as America's leading trading state, and one of its main distribution centres, is bound to grow. Governor Perry's plans for a "Trans-Texas Corridor", a

mighty new highway running north from Mexico across the state, was turned down as too expensive and disruptive, but large parts of it will be built anyway. Once the widening of the Panama Canal is completed in 2014, Houston will become an attractive port for Asian goods being shipped to the central and eastern states; it is already, in effect, the principal export port for prosperous northern Mexico.

Dallas-Fort Worth’s enormous airport lies at the centre of a large number of logistics and distribution centres. Again, having oodles of space to expand into is crucial; Los Angeles, New York and Chicago, America’s other big logistics centres, are all hemmed in.

Fourth, the memory of the 1980s banking crisis is still strong. Whereas banks in the rest of America have reeled, those in Texas remain in reasonable shape. Richard Fisher, the president of the Dallas Fed, puts it down to his state’s particularly effective regulation. He is biased, no doubt; but Texas law does cap the loan-to-value ratio of mortgages at 80%. Without a big property boom this time around, prices did not have so far to fall.

And financial services in Texas, having been almost wiped out in the 1980s, are now expanding. Dimensional Fund Advisors, which has $99 billion under management, moved from Santa Monica to Austin in 2006. Comerica, America’s 23rd-largest bank, according to *Fortune*, moved its headquarters from Detroit to Dallas a year later. Texas is not about to become a big national banking centre, but these are further signs that an economy of cotton, cows and drills has become a lot more diverse.

# The red and the blue

Jul 9th 2009
From The Economist print edition

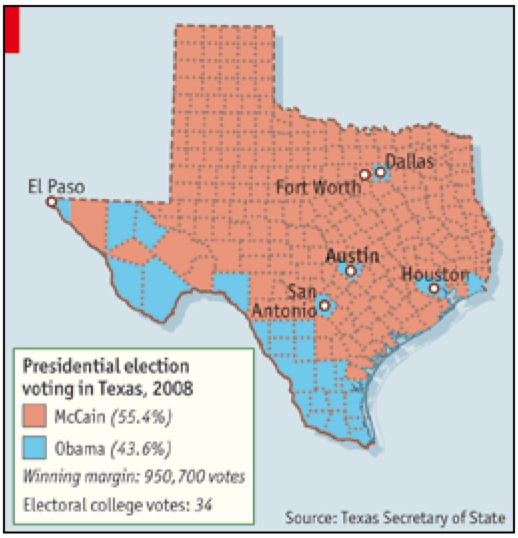
**Whisper it softly, but Texas looks set to become a Democratic state**

THE elected sheriff of Dallas County is a lesbian Latina. The leading candidates to become mayor of Houston in November include a black man and a gay white woman. The speaker of the House of Representatives is the first Jew to hold the job in 164 years of statehood and only the second speaker to be elected from an urban district in modern times. In this year's legislative session, bills to compel women to undergo an ultrasound examination before having an abortion (to bring home to them what they are about to do) and to allow the carrying of guns on campus both fell by the wayside; a bill to increase compensation for people wrongly convicted sailed through. Lakewood, in Houston, the biggest church not just in Texas but in America, claims to welcome gays. As Dorothy in "The Wizard of Oz" might have said, we're not in Texas any more.

Or at least, not in Texas as we have recently come to know it. A Democratic-voting Texas would be nothing new, but political memories are short, and the blunders of the Bush presidency have coloured global perceptions of what Texas is like. It mostly voted Democratic in presidential elections until 1968, when, alone among the former Confederate states, it went for Hubert Humphrey, and 1976, when it voted for Jimmy Carter. Many of those voters were highly conservative "Dixiecrats" and later flipped to the Republicans. But there has always been a strong radical streak too. William Jennings Bryan was hugely popular in Texas. Jim Hightower, a former Texas agriculture commissioner and the perennial voice of Texas populism, says that "Texas has always been a purple state"—up for grabs by either the red Republicans or the blue Democrats.

It had a Democratic governor, in the feisty and liberal shape of Ann Richards, until as recently as 1995; but since that year, which saw George Bush's ascent to the governor's mansion, the Republicans have been firmly in control, and no Democrat has won statewide office. Since 2003 the Republicans have controlled the House as well as the Senate, monopolising every lever of power in the state. Now the pendulum is swinging back.

With no prospect of a local son to vote for in future elections (a Bush has been on the ballot paper for six of the past eight presidential votes), the Republicans have lost one big advantage. In the 2008 election the Democrats did much better all over the state. They won the presidential vote in all the big cities except Fort Worth (see map). They made big inroads into the Republicans' dominance of the suburbs, where American elections are lost and won these days. Overall they took 44% of the vote, up from 38% in 2004, even though Barack Obama barely campaigned in Texas.




They secured a blocking minority, 12 seats out of 31, in the heavily gerrymandered state Senate, and almost took control of the Texas House of Representatives: the Republicans now hold it by just 76 seats to 74. The conservative speaker was promptly ousted and replaced by Joe Straus, who depended for his election on a sizeable block of Democratic votes.

The mild-mannered and charming Mr Straus has turned out to be a bipartisan and moderate figure, though he insists that he made no promises to the Democrats who backed him. But this year's legislative session showed the Democrats flexing their muscles in the House, blocking a bill on voter identification that they said discriminated against their supporters.

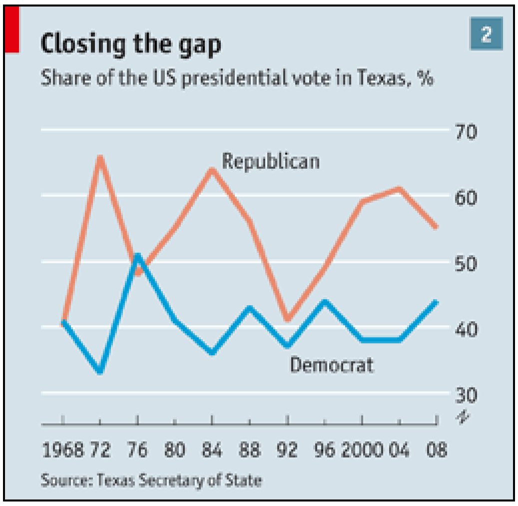
The rise of the Democrats poses a dilemma for Republicans in Texas, just as it does nationally. And just as the national party seems to be lapsing into fratricide, so a vicious internal war has broken out over the governorship. Rick Perry is running for a third full term in the job, but the main challenge he faces is not from the Democrats who, oddly, have come up with a remarkably unconvincing candidate: Tom Schieffer, who used to be Mr Bush's business partner

and who is famous mainly because his brother is a TV presenter. The real rival is within, in the shape of Kay Bailey Hutchison, probably the most popular politician in the state. Mrs Hutchison has served as one of Texas's two senators in Washington, DC, since 1993, and was last re-elected in 2006 with 62% of the vote.

## Internecine warfare

Mr Perry has a strong economic record to run on, but because his toughest fight is against a fellow Republican, this has already turned into a battle for the souls of the 600,000 conservative sorts who vote in the Republican primary, due to be held next March. Mr Perry has lurched to the right to woo this atypical electorate.

Thus, he has backed allowing "Choose Life" to be an official Texas car licence-plate motto. This hurts Mrs Hutchison, who is in trouble with social conservatives for having once voted against overturning *Roe v Wade*, the Supreme Court decision that protects the right to abortion. He has also refused to take up a big chunk of the stimulus funds offered to Texas to help pay unemployment benefit, on the ground that this would create a long-lasting obligation.




No one doubts that Mrs Hutchison would beat Mr Perry or anyone else in Texas in a general election, but recent polls have her lagging behind Mr Perry in the primary. If she does formally enter the race, as expected, she will have to face being branded as a baby-killer and a creature of spendthrift Washington, DC.

Mrs Hutchison insists that "it's very important that we don't build a party around an issue [abortion] that is so personal, on which even families disagree." She is surely right, but primary voters may not see it that way. This race matters hugely to Texas: it is a moment when the state's Republicans will have to decide which wing of the party they are on.

The Democrats, meanwhile, are pinning their hopes for the 2010 election on securing a majority in the state House of Representatives and on winning a US Senate seat (which may come up sooner if Mrs Hutchison resigns to concentrate on her race for governor). Their chances in the House are good: as the recession starts to bite in Texas, later than elsewhere in the country, support for the Democrats is likely to rise. On the other hand Barack Obama will not be at the head of the ticket in 2010, as he was in 2008—though in Texas he was never quite the draw he was on the coasts.

AP

The steady rise in the Hispanic population, coupled with a slow but continuous increase in Latinos' tendency to vote, bodes well for the Democrats. George Bush did an impressive job courting the Hispanic vote, but the Republican Party threw that advantage away by rejecting his plans for immigration reform in 2006-07. In the 2008 presidential election Texas Latinos voted Democrat by 63% to 37%. Mr Obama's nomination of the first Hispanic Supreme Court justice is unlikely to hurt, and nor will his commitment to immigration reform. As Hispanics increasingly spread out across the state they will start to tip the balance in many suburban counties, which is where the big political battles in America are being fought.

In the Senate race the Democrats' probable candidate will be Bill White, the current mayor of Houston. He has done an excellent job balancing the needs of business with those of his core voters, and he will have a lot of money behind him.

Texas had become used to being at the centre of events, having supplied the president, the vice-president or at least the treasury secretary for all but a handful of the past 50 years. Now it does not even have a senator in the majority party, meaning that Texas has no voice in any of the big deliberations in Washington, DC. That will

help the Democrats too.

But it does seem fair to ask what Texas Democrats actually stand for. They say they want more money spent on health and education, but pretty much every politician in Texas says the same, and the party's leadership shows no appetite for delivering this by taxing Texans more heavily. Hardly anyone seeks to abolish the death penalty, even though, in most years, Texas executes as many people as the rest of America put together. Gun control and recognition of gay marriage are off the table. Everyone has jumped on the renewable-energy bandwagon.

It would, in short, be possible to imagine Texas slipping back to the Democrats without much happening in consequence, except for two considerations. The first is that, should Texas go Democratic at the presidential level, the Republicans nationally would be in deep trouble: with its 34 electoral-college votes, Texas is the only big state they have regularly won in recent presidential elections. The second consideration is the Hispanics. As they become ever more powerful in an ever stronger Democratic Party, there is every chance that they will turn against a model that has left far too many of them behind.

**And now for someone completely different**

Economist.com SPECIAL REPORTS

# The new face of America

Jul 9th 2009
From The Economist print edition

**Texas is the bellwether for demographic change across the country**

AT THE age of 34, Julian Castro has pulled off a remarkable feat. On May 9th, without even the need for a run-off, the polished young lawyer won the race to become mayor of San Antonio, the largest Hispanic-majority city in America and the seventh-biggest city in the entire country. He joins Antonio Villaraigosa, the mayor of Los Angeles, as one of America's half-dozen most prominent Hispanics.

The curious thing is that Mr Castro is only the third Hispanic mayor in San Antonio's long history; the first, Henry Cisneros, was elected only in 1981. America's Hispanics have a long way to go before they enjoy the influence that their numbers suggest. "We do have a history of failing to participate," he admits. "But we have been seeing a series of big advances."

Things are indeed changing. At the national level voter turnout among Hispanics was 49.9% last year, up from 47.2% in 2004, though still much lower than the non-Hispanic whites' 66.1%. The body to watch is the Mexican American Legislative Caucus (MALC), which claims 44 of the 74 Democrats in the Texas House (there is not one Hispanic Republican there, a gigantic problem for the party). Trey Martinez Fischer, who chairs MALC, is another young man in a hurry. "MALC is taking over the Democratic Party here," he says, "and it is time for us to expand our footprint."

The most pressing issue, he reckons, remains education. "We are creating a majority population here that is limited in its skill set. It is up to us: if we don't act, we are heading for disaster." But it is not just education; Hispanics, he says, are poorly served when it comes to access to capital, health care and public transport. "This state", he says, "has not yet atoned for the sins of its past."

You only need to tour the Rio Grande valley, which stretches from Brownsville in the east up almost as far as Laredo, to see what he means. The valley includes some of Texas's fastest-growing and most successful counties, such as Cameron County around Brownsville and Hidalgo County around McAllen; Brownsville has boomed, thanks in large part to its port, which serves Mexico's buoyant north. McAllen has also become a favoured place for rich Mexicans to buy homes, educate their children and squirrel their money away; its mayor, the engagingly town-proud Richard Cortes, has big plans for an arts district, upmarket shopping centres, a huge public library which he says will be the fifth-largest in the country, and much else.

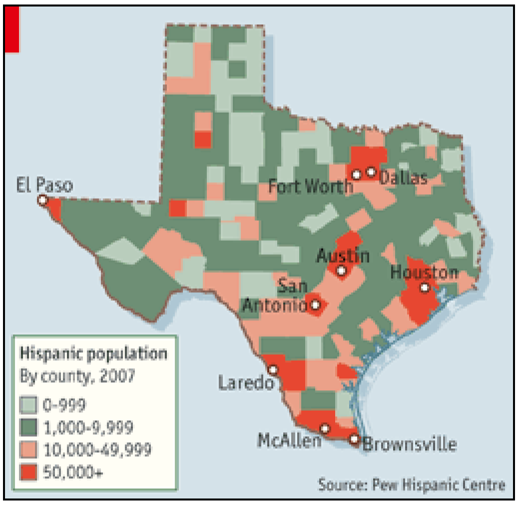
## Down in the valley

But you can also encounter poverty on a scale hard to find anywhere else in America. More than 30% of the valley's population still falls beneath America's official poverty level, according to Sister Maria Sanchez of Valley Interfaith, a local charity. The poorest among them are to be found in the *colonias*, small settlements outside recognised towns. There are around 2,300 *colonias* in total, and the worst of them still have large numbers of houses without running water. In recent years state money has hugely improved some of them, such as Las Milpas, outside McAllen. Others, like Los Altos outside Laredo, are a national disgrace. "We are the richest country in the world, and we still have this," says Jaime Arispe, of the Laredo Office of Border Affairs, as he surveys a street that looks as if it could be in Port-au-Prince.

Others echo Mr Martinez Fischer's views, if not quite the passion with which he expresses them. Rafael Anchia, another House member, was recently tipped by *Texas Monthly* as the first Hispanic governor of Texas—though not until 2018. He brushes the accolade aside, but like Mr Martinez Fischer says that the state has systematically underfunded public education and insists this will have to change.

Health care is another racial issue. Texas has the worst insurance-coverage rates in America, and Hispanics, as well as blacks, fare much worse than Anglos; most Americans get their health care through their companies, but Hispanics and blacks are

more likely to work for employers who provide limited benefits or none, or to be unemployed.




The flaws in the American health system are mostly a federal matter, but Texas makes them worse by failing to take up available federal dollars because of the need for co-finance by the recipient state; by providing few public clinics; and by refusing to reimburse private hospitals for the cost of emergency care for people who cannot afford to pay, forcing them to jack up prices for others. It also operates one of the least generous subsidy regimes for poor children in the country.

The reason why MALC will have to be listened to on all these counts is demographic. The Hispanic population is constantly being reinforced by the arrival of immigrants from across the Rio Grande, though economic, political and security pressures have started to make the border less permeable.

But international migration is not the main driver of Texas's booming population. Texas's Hispanics, on average, are younger than the Anglos, and their women have more babies. In 2007 just over 50% of the babies in Texas were born to Latinas, even though Hispanics make up only 38% of the population. Over the eight years to 2008, reckons Karl Eschbach, Texas's official state demographer, natural increase (which favours Hispanics) accounted for just over half the 3.5m increase in the state's population, and migration from other states for almost half of the rest.

Even if the border closed tomorrow, Hispanics would still overtake the Anglos by 2034, reckons Mr Eschbach. Recent trends suggest that this will in fact happen by 2015. More than half the children in the first grade of Texas schools are Hispanic. And in the Houston public-school district the proportion is 61%, notes Stephen Klineberg, of Rice University. (African-Americans make up another 27%.)

Getty Images

**Pledging allegiance**

Nor is it only Texas that is undergoing profound demographic shifts, says Mr Klineberg. Texas today is what all of America will look like tomorrow. At the moment there are only four "minority-majority" states (that is, states where non-Hispanic whites, or Anglos, are in the minority): California, Texas, Hawaii and New Mexico. He expects the 2010 census to show as many as 10-12 states to have passed that milestone; by 2040, he thinks, America itself will be a minority-majority nation.

The geographical spread of Texas's Hispanic population has changed in a way that will change the state's politics. Most Latinos used to live south of the I-10, the motorway that joins San Antonio to Houston, notes Mr Anchia. But now Dallas, like Houston, has considerably more Hispanics than Anglos: a little over 40% of the population against around 30%. Mr Anchia himself represents a district that includes part of Dallas and a swathe of prosperous suburbs, including some where there have been nasty rows about illegal immigration.

Even public schools up in the once lily-white panhandle in the north of the state are seeing their classes

fill up with Hispanic children; to take a random example, in tiny Stratford up on the border with Oklahoma some 54% of the children at the local high school are Hispanic. “Every single institution in this state was built by Anglos for Anglos,” says Mr Klineberg. “And they will all have to change.”

## Come on in

That might be easier than it sounds. Texas has proved far better than the other border states (California, New Mexico and Arizona) at adapting to the new, peaceful *reconquista*. In California, Proposition 187, which cracked down hard on illegal immigration, was heartily backed by the then Republican governor and passed in a referendum in 1994, though it was later struck down by a federal court. This kind of thing has only ever been attempted in Texas at local level, and even then only very rarely.

Texas has always been a strong supporter of immigration reform that would offer illegal immigrants (of whom Texas has close to 2m, about 7% of its population) a path to citizenship. It has also always favoured NAFTA. Perhaps that is because Texas was itself Mexican until 1836. For centuries the border, demarcated by the Rio Grande, was entirely porous, and its very length meant that much of Texas felt joined to Mexico—a cultural affinity evidenced in the fact that the *margarita* and the *fajita* were both invented in Texas.

Only recently, at the behest of distant authorities in Washington, DC, has this sense of propinquity seemed to weaken. Driven by anger elsewhere in America, immigration officials raid businesses looking for workers with false Social-Security numbers. Driven by post-2001 fears, the number of Border Patrol officers is being increased from 6,000 in 1996 to 20,000.

Texans don’t like this much. In April Jeff Moseley, president and CEO of the Greater Houston Partnership, the city’s chamber of commerce, made a powerful speech to a Senate hearing in Washington in which he rebutted the notion that undocumented workers are a drain on America’s resources. According to a study he presented, they are more likely to be net contributors in fiscal terms. He argued that they mostly complement rather than compete with domestic workers, and that they are less likely to commit crimes than the native population. And he pointed out that cracking down on illegals has had a perverse effect, ending a pattern of seasonal or circular migration that has served Texas well for many decades. Instead, it has encouraged the use of people-smugglers bringing across whole families who then tend to stay. It has fenced people in, not out.

Mr Moseley used the word “fence” calculatedly. Down in southern Texas there is no five-letter word more likely to provoke anger. The way Texans see it, the fence that is being built along a third of America’s 2,000-mile long southern border is an expensive waste of time. It sends an appalling signal to a friendly neighbour; it is easy to climb over, with or without a ladder; it is easy to circumvent; it is bad for the environment, because it cuts off animals from their water sources; and it tramples on the rights of landowners, since it has to be built well back from the riverside so as not to interfere with flood channels.

But if the fence itself is likely to have little effect on illegal immigration, the fear of terror that gave rise to it, coupled with the recession on both sides of the border and Mexico’s murderous struggle with the drug lords in its border cities, are certainly affecting both the legal and the illegal sort of crossing. Everyone along the valley of the Rio Grande seems to believe that the border is slowly closing.

At the extreme eastern end of the border, Jude Benavides, an ecologist at the University of Texas at Brownsville, laments how life has changed. “Three of my four grandparents are from Mexico,” he says. “We used to cross over the bridge to Matamoros just for lunch or dinner. Now we don’t go. We are scared of the violence, and it can sometimes take as long as two hours in line to get back across.”

The economy, too, is a powerful reason why people are crossing less often. The Mexican peso has fallen by 18% against the dollar since the beginning of 2008. That has hit retailers on the American side hard. Mexicans in the northern border provinces have been hurt by the collapse of America’s car industry. Many of the *maquiladoras*, factories set up just on the Mexican side of the border to benefit from lower wages and land costs, have specialised in making parts for Detroit. One of Texas’s main assets is a bit distressed just now.

## Don’t mess with Texas

So Texas has a huge challenge to cope with. But it seems wrong to end on a pessimistic note. Texans above all are optimists, and few of them seem to doubt that Mexico’s proximity is a huge long-term source of strength for the Lone Star state. That optimism, rooted in a profound sense of local pride that can sometimes jar with outsiders, is Texas’s dominant characteristic.

It is the reason why the wildcatter, the independent oilman whose test drillings might come up dry 20 times before gushing in the end, is an enduring Texas symbol. And it explains why risk-taking is admired and failure no disgrace. Most of the Enron executives who lost their jobs when the firm went bust in 2001 quickly found new ones. The company’s offices in Houston were swiftly re-let. Enron Field baseball stadium became Minute Maid Park. “Don’t mess with Texas” was once a slogan for a wildly successful anti-litter campaign. It is now the state’s unofficial motto.

To visit America in the midst of the worst recession for decades can be a disheartening experience, but a tour of Texas is quite the reverse. Since suffering that big shock in the 1980s, it has become a well-diversified, fiscally sensible state; one where the great racial realignment that will affect all of America is already far advanced; and one whose politics is gradually finding the centre. It welcomes and assimilates all new arrivals. No wonder so many people are making a beeline for it.

# Sources and acknowledgments

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Sources:

For facts and figures, one good resource is the Texas Almanac

Up-to-date state economic data, including government projections, is given by the Texas Comptroller

The Dallas Fed also has lots of useful data and analysis

Two excellent think-tanks are the Centre for Public Policy Priorities, for a left-of-centre take; and the Texas Public Policy Foundation, for a more market-oriented view

Interesting rankings of American states for various contributing factors to growth can be found in Arthur Laffer's Rich States, Poor States competitiveness index

The Kauffman Foundation's work on factors boosting entrepreneurship is in "The 2008 State New Economy Index"

For politics, *Texas Monthly* is an essential read, especially Paul Burka's work

For demographic data, the best source is the Office of the State Demographer

Four books which informed the special report are: "Lone Star", by T.R. Fehrenbach; "Mongrels, Bastards, Orphans and Vagabonds: Mexican Immigration and the Future of Race in America", by Gregory Rodriguez; "The Next American Nation" and "Made in Texas", both by Michael Lind

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## Hollywood in the recession

# One-dimensional

Jul 9th 2009 | LOS ANGELES
From The Economist print edition

**The downturn forces sweeping changes on a reputedly recession-proof business**

Alamy

JOHN DAVIS has produced films such as “I, Robot” and “Norbit”, and is working on an adaptation of “Gulliver’s Travels”. He also invests in businesses as diverse as restaurants and scaffolding. These days he is much more optimistic about the film industry than anything else. It is a measure of the recession’s severity that a business built on fickle teenage audiences and multi-million-dollar wagers has come to seem comparatively reliable.

The downturn has affected Hollywood in a way that few expected. Michael Lynton, head of Sony Pictures Entertainment, says that if he had been asked to predict whether the recession would encourage people to stay at home watching the large televisions on which they had spent so much or go out to cinemas, he would have guessed wrong. So far this year box-office receipts are up by 12% over last year. Yet sales of DVDs are falling (see article).

Odder still, the film business is proving hardier than the conglomerates of which the big studios are a part. Sony made ¥30 billion ($299m) on film and television in the year that ended in March, but it lost ¥168 billion on electronics. Disney, Fox and Universal used to rake in profits from their local television stations; the slump in car advertising has put an end to that. Time Warner has been weighed down by AOL and magazines. So the message has been dispatched to Tinseltown: spend less money, and do not do anything risky.

Unfortunately that has become difficult. Last year a torrent of Wall Street money, which had allowed the big studios and independent outfits to share the risk and expense of making films, abruptly dried up. Equity investors have learned, like many before them, that the film business produces better parties than profits. Domestic lenders are concentrating on repairing their balance sheets; foreign ones are being pressured to focus on their home countries. David Shaheen, head of the entertainment group at JPMorgan, reckons there were 25 to 30 banks active in film financing before the credit crisis. Now there are no more than 12.

As a result there will be fewer films. According to the Motion Picture Association of America, 606 new films were released last year, although many were destined for just a handful of cinemas in New York and Los Angeles. This year the number can be expected to drop to 400 or below. It will not happen immediately. The film business is like a snake digesting a large meal: the production bulge caused by the surge of money in 2006 and 2007 will take a year or so to work its way through the system.

The prospect of a slowdown rather cheers the studios and the larger independent distributors. In retrospect, they reckon, the ready availability of film financing meant too many titles were competing for

attention. With a clutch of new releases every Friday, steep drop-offs in audiences have become routine. Ticket sales for “Wolverine” fell by 69% between the first and second weekends of its release in May. And that film was a success.

Better yet, from the studios’ point of view, the price of talent is falling. With fewer films being put into production it is a buyers’ market for actors and directors—one reason an actors’ strike failed to materialise this year. Middling stars are being offered much smaller guaranteed fees in return for a bigger cut of the profits if a film sells well on DVD and television. The top tier of talent still commands huge sums. But that club has shrunk, in part because big-budget films these days are sold less on the appeal of an actor than on familiarity with the television programmes, books or comics that so often inspire them.

The films loaded with special effects that dominate the summer and Christmas holidays will not, however, become much less common or cheaper to make. In the past few years films costing more than $150m to produce have proven reliably profitable. Healthy returns this summer from 3-D animated films, which are more expensive to make than the two-dimensional sort, are encouraging studios to put more into production. Nor are the studios likely to tinker much with their carpet-bombing approach to marketing big films. After all, the cost of advertising is falling.

Kevin Misher, the producer behind “Public Enemies”, believes the film business will become increasingly polarised. There will be plenty of spectacular, big-budget summer action films and a steady supply of cheap comedies (at a big studio, a “cheap” film is one that costs less than about $40m to produce). What these films have in common, Mr Misher points out, is that they promise a collective experience. People like to watch spectacular action films, comedies and horror films in groups and will abandon their televisions and mobile phones to do so.

The inevitable losers in all this will be complex, well-made films that do not fit neatly in a single genre, such as “Duplicity”, a hybrid of comedy, drama and romance starring Julia Roberts and Clive Owen. It failed at the box office earlier this year. Studio executives have long known that such films are chancy. The ease of spreading financial risk allowed them to suspend their disbelief. No longer.

Hollywood’s ability to respond quickly to change has helped the film business to remain stable, with the same number of big studios now as in the early 20th century. Yet the new austerity comes at a cost. Cutbacks in development and production mean studios will have fewer films to release when the recession ends. That means less potential profit from discs, television rights, toys and the rest of it—not to mention less variety for filmgoers.

**Resuscitating the DVD**

# Floppy discs

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**The DVD is not dead, but its best years are behind it**


IT IS the hottest topic in Hollywood: is the DVD dying? Ten years ago the discs rejuvenated the film business. DVDs not only offered cleaner pictures and better sound than videotape; they also looked smarter on bookshelves. People were persuaded to own films rather than simply watch them. Studios began to make twice as much from disc sales as from cinema tickets. But DVD sales, which began declining gradually in 2006, are now falling more steeply (see chart). And there is always the threat that online piracy might take off.

There is probably still some life in the format—but that does not mean Hollywood can relax. About one-third of the drop in DVD sales in the first quarter was counteracted by rising sales of high-definition Blu-ray discs, which are more profitable. Much of the remainder can be put down to belt-tightening amid the downturn. “People are still going into the shop and buying a DVD; they just aren’t buying two or three DVDs,” says Amir Malin of Qualia Capital, a media investment firm.

Yet people are still getting hold of films. In the past year the value of DVD and Blu-ray rentals increased by 1%, according to Rentrak. In a generally dismal climate for media companies two outfits are thriving. Netflix, which rents DVDs and Blu-ray discs by post, signed up 25% more customers in the past year. Redbox, which rents films cheaply from self-service kiosks, has been adding machines at the rate of more than 500 per month. Many kiosks are located in the same shops that sell discs. The real worry, then, is not that people are abandoning DVDs but that they are abandoning the notion of owning them.

Studios would prefer people to get their films in almost any way other than renting them from a kiosk. It is much more profitable to stream a film digitally or sell it through a cable operator as a video-on-demand (VOD). Recognising this, Warner Bros now releases many films simultaneously on DVD and VOD. The big studios have overcome their initial reluctance to sell digital copies of films through Apple’s iTunes store. Although it is a long way off, there is much talk of creating a premium VOD “window”, charging perhaps $40 for a film soon after it appears in cinemas. “We need to give people as many options as possible without confusing them,” says Kevin Tsujihara, head of home entertainment at Warner Bros.

Meanwhile strenuous efforts are under way to stimulate disc sales. Disney is selling some films in three formats in a single box—DVD, Blu-ray and digital file. Studios are adding puzzles, interviews and other special features to discs intended for sale, but not to discs intended for rental. Mike Dunn, head of home entertainment at Fox, sums up the strategy: “If you buy a Blu-ray disc you get a BMW. If you rent one you get a Chevrolet.”

Google v Microsoft

# Breaking Windows

Jul 9th 2009
From The Economist print edition

**Google takes its rivalry with Microsoft a step further**

THE announcement came as a humble blog post on Google's corporate website late on July 7th, but it heralds what could be a dramatic shake-up for the information technology (IT) industry. By promising to launch a free operating system for personal computers (PCs) later this year, the online giant is mounting a direct attack on Microsoft and its dominant Windows operating system. TechCrunch, a technology blog, reported the news as "Google Drops A Nuclear Bomb On Microsoft".

The bomb has a very long fuse, however. The first machines running Chrome OS, as the new software is to be called, will not be available until late next year. The initial version will only be suitable for netbooks, the small, cheap laptops that have proved popular of late. The idea is to provide a compact and simple-to-use operating system that boots up in a few seconds and works securely and easily with web-based applications, such as social networks and online e-mail. The software will combine Linux, the open-source operating system, with Chrome, Google's browser.

But Google's intention is clear. It plans to do what the now-defunct Netscape attempted when it launched its first web browser in the mid-1990s: to make Windows obsolete and turn the browser into the dominant computing platform. All applications written for Chrome OS will be web-based, although it will allow users to work offline and synchronise changes later. That means Chrome OS applications will also work with other browsers that are compliant with the latest web standards.

Microsoft has not yet officially responded. But Google's assault comes at a time when the once-omnipotent software giant looks vulnerable. Windows Vista, the most recent version of its operating system, has not been a success. Its forays into Google's main territory, web search and online advertising, have not brought big gains.

Yet it is much too early to count Microsoft out. It recently launched Bing, a new search service, which has been well received. In October, around the time when Google will make Chrome OS available, Microsoft will release Windows 7, the much-improved next iteration of its operating system. The firm is also spending billions of dollars on a "cloud"—a global network of huge data centres—which will rival Google's infrastructure for web-based applications.

Will there be a clear winner? Probably not in the foreseeable future. That is a good thing: the epic fight between the two giants promises to speed up innovation, which is what the recession-bound IT industry most needs.

The Algosaibi and Saad groups

# The fallout from a falling out

Jul 9th 2009
From The Economist print edition

**A drama involving two Saudi conglomerates shakes the region**

“THE family is the kernel of Saudi society,” according to the kingdom’s Basic Law. Families are also at the core of Saudi capitalism, owning the vast majority of the country’s firms. But problems affecting two of the kingdom’s most prominent family conglomerates may yet be the kernel of a wider crisis.

On one side is the venerable Gosaibi family, owners of the Ahmad Hamad Algosaibi & Brothers Company (AHAG). With their roots in farming and pearling, the Gosaibis now make their money from finance, property and shipping, as well as coating pipes, making cans and bottling Pepsi. On the other side is the Saad group, an investment company headed by Maan Al-Sanea. Born in Kuwait, where he trained in the air force, Mr Sanea married into the Gosaibi family. The billionaire’s group, named after his deceased son, accumulated assets all over the world, including substantial stakes in Berkeley, a British homebuilder, and HSBC.

Saudi companies like to keep their problems within the family. But the difficulties at AHAG and the Saad group are proving impossible to contain. In May The International Banking Corporation (TIBC), a Bahraini bank owned by the Gosaibis, defaulted. Later that month Saudi Arabia’s central bank froze the personal accounts and property holdings of a number of members of the Gosaibi family, including Mr Sanea. *The Economist* has learned that the Saudi Arabian authorities have also barred Mr Sanea and others from leaving the country (his lawyers will not comment on this, although they vehemently protest his innocence).

Following the central bank’s action, the Saad group suffered what it describes as a “liquidity squeeze”. Creditors refused to roll over loans, and the central bank of the United Arab Emirates instructed its banks not to lend to the group. To raise money, the group sold many of its shares in Berkeley and 3i Infrastructure, an investment firm.

In a statement the Saad group acknowledged that its predicament owes something to the “failure of companies owned by a prominent Saudi family business”, presumably AHAG. It also says it is working to resolve a “private family dispute”. But the nature of that dispute is unclear. Last month Bloomberg reported claims by a Gosaibi spokesman that TIBC was managed by Mr Sanea. He strongly denies this, insisting that any business ties between himself and AHAG companies are on an “arm’s length commercial basis”.

On June 24th the Gosaibis held a creditors’ meeting in Bahrain. Their representatives revealed that the group owes $9.2 billion to over 120 banks all over the world. (“Put a world map in front of you, start on the left, and go country by country,” says one banker.) The group’s assets, according to sources familiar with the matter, fall far short of its debts. The Gosaibis would not comment on these figures. They do claim to have found evidence of “substantial financial irregularities” in the group’s financial-services arm. They have reportedly asked their creditors for a 90-day standstill, while they dig deeper, though AHAG would not confirm this.

The scale of the borrowing inspired “shock and awe” among the creditors, according to a person familiar with the matter. Algosaibi was a “very solid corporate name in the region”, says one banker. Many creditors lent to the group on the strength of the name alone. Thanks to its reputation, AHAG may have escaped the closer scrutiny a lesser name would have expected from its creditors.

The group will probably get its 90-day reprieve. But a reckoning, for the group and the kingdom, cannot be deferred forever. Some creditors are “so numb they don’t know what to do,” according to one banker. “Others are saying: ‘That’s it. End of story. No more lending in the region.’” The banker hopes the royal family will step in quickly to resolve all this and, if necessary, take over the conglomerates. The groups’ troubles will have a “colossal” impact on the Gulf, he says, “unless there is some divine intervention”.

**Exelon's takeover bid for NRG**

# Power struggle

Jul 9th 2009 | NEW YORK
From The Economist print edition

**The battle to create America's biggest electricity generator continues**

AFP

Exelon is steaming

IT IS not so much a takeover battle as a war of attrition. It was back in October that Exelon, America's biggest owner of nuclear-power stations, first offered to buy NRG Energy, a big generator which focuses on Texas and relies mainly on coal and natural gas. Exelon wants to create America's biggest electricity generator, with a capacity of more than 47,000 megawatts, enough to power 45m homes. But NRG's management rebuffed the all-stock deal, and its shareholders, at first enthusiastic, got cold feet as NRG's rising share price made the terms less generous. Earlier this month Exelon raised its offer by 12%, but NRG's management rejected the sweetened deal, now worth about $7 billion, on July 8th. The next skirmish will come at NRG's annual meeting on July 21st.

The two firms are bombarding one another in barbed letters and spiky press conferences. David Crane, NRG's boss, says that Exelon continues to undervalue NRG, noting his firm's recent purchase of Reliant, a Texan power retailer. Exelon's boss, John Rowe, has said that NRG's management is simply being stubborn. NRG even filed a lawsuit claiming that Exelon had misrepresented its bid, but it was thrown out by a federal court last month.

Several recent projects have boosted NRG's share price. It has built a wind farm in Texas and started work on a solar farm in California. It also plans to build two nuclear reactors in Texas, for which it is likely to receive loan guarantees from the federal government. By contrast, the government decided not to guarantee loans for a nuclear plant proposed by Exelon, prompting the firm to drop the scheme last month.

Exelon has also been hit by tumbling electricity prices in the Midwest, the heartland of its business. Prices have fallen from around $60 per megawatt-hour last summer to $20-30 this summer. They are strongly tied to the prices of natural gas and coal, which have both fallen too. So NRG, with its fossil-fuel plants, at least benefits from lower costs as electricity prices fall. Since most of Exelon's power stations are nuclear, it does not.

But in the longer term Exelon is in a strong position. Under the cap-and-trade legislation working its way through Congress, coal looks more expensive in the long run and nuclear, with no greenhouse-gas emissions, more attractive. Little wonder that Exelon supported the bill enthusiastically: management sees a billion-dollar annual boost in earnings should it pass. In other words, the two firms have different strengths—which is why they might make a good match.

Economist.com BUSINESS

Signs of hope for the car industry

# Living on scraps

Jul 9th 2009
From The Economist print edition

**The worst may be over for carmakers, but they are still in for a long haul**

CALL them green fumes. Sales of cars and trucks in America showed their smallest year-on-year decline last month since September, when Lehman Brothers crashed—although the drop was still a massive 31%. That would correspond to annual sales of 9.7m. But according to General Motors, the first three weeks of the month were a good deal better, running at a rate of 10.3m. Sales subsequently slowed as some customers held back in anticipation of the federal "cash-for-clunkers" scheme, which began this month.

Such incentives appear to be working well. Data released this week by J.D. Power Automotive Forecasting showed that during June, car sales in Western Europe grew by 4.1%. In Germany, which has the most generous of the many scrappage schemes in operation, sales were up by an astounding 40.5% for the month and 26% for the year so far. Monthly sales rose by nearly 12% in Italy and by 7% in France.

Although the American scrappage incentives apply from July 1st, buyers may hold back until the details of the plan are finalised later in the month. That could turn out to be good news for General Motors. This week's decision by Judge Robert Gerber to allow the "new" GM to acquire the good assets of "old" GM, following the example set by Chrysler's fast-track exit from Chapter 11, should ensure the emergence from bankruptcy of America's biggest carmaker within weeks. Having lost nearly two percentage points of market share during the bankruptcy proceedings, the new GM is planning a marketing blitz next month to announce its resurrection.

The industry is fearful about what will happen when the various scrappage schemes are phased out (all are limited either in time or funding). There is a widespread belief that the incentives, which range in value from about €750 ($1,050) to €2,500 and are only available to buyers with cars over ten years old, are only "pulling forward" demand and will thus enfeeble the recovery when it comes.

Sascha Heiden of IHS Global Insight, a forecasting firm, thinks the scrappage schemes in Western Europe will boost sales by about 1.2m this year and reduce them by 600,000 next year. But Max Warburton of Bernstein Research argues that most of the sales "are new and incremental, rather than pull-forward", since customers with nine- to ten-year-old cars usually replace them with used instead of new ones. Mr Warburton believes that "normal" buyers of new cars will begin to return to the market next year as the economy improves. He expects Western European sales to be roughly stable in 2010, but with demand for bigger and more profitable vehicles replacing the artificial surge in demand for small, cheap cars.

There are other reasons for the industry to feel more optimistic. Inventories have now been almost fully depleted, paving the way for a jump in production in the last four months of the year. A pronounced increase in American vehicle sales, which fell by 40% towards the end of last year and have stayed at their lowest level since the 1970s, is a near certainty. Although rising unemployment will continue to act as a drag on the market, car loans, the lifeblood of the industry, have become available again, even to less-than-prime borrowers.

Mr Warburton also points to a recovery in profitability, thanks to falling raw-material costs, that should be worth as much as €500 a car next year. Nor should the positive impact on carmakers in both America and Europe of a radically slimmed down GM be underestimated. GM, says Mr Warburton, has been "the overriding deflationary force on industry pricing" for decades.

There is still uncertainty about when mature car markets will return to the kind of sales seen in the decade up to 2007 (according to IHS Global Insight it will not be for at least four years) and who will be the winners and losers among the big carmakers. But for now, it is enough that the worst of the nightmare seems to be over.

## The bankruptcy of Christian Lacroix

# End of season

Jul 9th 2009 | PARIS
From The Economist print edition

**Lessons for the luxury industry from the demise of a famous brand**

AP

**Restraint, Lacroix-style**

IN THE end a shortage of cash brought out the best in Christian Lacroix, a fashion designer whose *couture* house filed for bankruptcy in May. Unable to spend freely on what was probably his final show on July 7th, he presented restrained, wearable clothes in just a handful of colours—a far cry from his usual baroque fantasies.

Mr Lacroix's fashion house had lost money every year since it was founded in 1987 inside LVMH, a luxury-goods group. LVMH's plan was to create a fashion house which would sell products from *haute couture* to handbags and perfume. But Lacroix never had a hit perfume or an "it" bag. In 2005 LVMH sold the firm for a nominal sum to the Falic Group, owner of Duty Free Americas, a retail chain.

Mr Lacroix persuaded the Falic Group to take the brand further upmarket. The new owners closed two cheaper but profitable lines, Jeans and Bazar, and raised prices for ready-to-wear. A plan to develop accessories never took off. That left the firm particularly vulnerable to the recession. Department stores in America have sharply reduced orders. Last year Lacroix made a loss of €10m ($15m) on sales of €30m.

High-end fashion turns out to be more susceptible to downturns than leather goods or other accessories. Even *haute couture*, says Luca Solca, an analyst at Bernstein Research, is not immune to the downward pressure on prices exerted by high-street brands such as Zara. Moreover luxury firms need their own shops to weather adversity. "If you rely mostly on wholesale channels such as department stores you are highly vulnerable," says Pierre Mallevays of Savigny Partners, who oversaw the sale of Christian Lacroix by LVMH and recently advised the Falic Group on options for the firm.

Outsiders seldom succeed in turning around a luxury brand. Permira, a private-equity firm which bought the Valentino fashion house in 2007 for €5.3 billion, is another cautionary tale. Valentino is trying to renegotiate its debt and Permira has reportedly written down its investment by roughly half. But the economic crisis is likely to produce attractive acquisition opportunities for luxury's three giants—LVMH, PPR (another French conglomerate) and Richemont (a Swiss firm)—although they are all likely to stay well clear of Mr Lacroix.

Face value

# Upwardly mobile

Jul 9th 2009
From The Economist print edition

**Peter Chou wants to turn HTC, which used to make mobile phones for other firms, into a brand in its own right**

HTC


THE pockets of Peter Chou, the chief executive of HTC, a Taiwanese handset-maker, are bulging. He likes to carry his firm's forthcoming gadgets around with him. At HTC's headquarters near Taipei, he recently dug out no fewer than six handsets. But if HTC fulfils its ambitions, Mr Chou will need to start wearing cargo pants. The firm has long toiled in obscurity as an "original design manufacturer", or ODM, quietly developing and building high-end "smart" phones for leading Western mobile operators, including Verizon and Orange. Now he wants his firm to become a household name alongside Apple and Nokia. HTC is releasing a new phone, the Hero, in Europe later this month (consumers in Asia will have to wait until later in the summer, and in America until autumn), which it hopes will be a step in this direction. If its transformation succeeds, the firm will become a model for other Asian technology companies.

Mr Chou can sound more like a Californian management guru than an Asian corporate patriarch. He says of his employees, "Instead of telling them what to do, I want people to have the freedom to explore their talent." That, after all, is what he had. In high school he was already passionate about all things electric. At university he decided to focus on computers. In 1972 he joined Digital Equipment Corporation (DEC), a leading American computer-maker which had set up shop in Taiwan. "That's where I learned the deep-engineering process: turning a concept into a mature product," he says.

Yet DEC ran into trouble, leaving little time or money for the sort of innovation that interested Mr Chou. In 1997, even before DEC was acquired by Compaq (which was later swallowed by an even bigger fish, Hewlett-Packard), he jumped ship and joined the team that would go on to start HTC, which once stood for High-Tech Computer, a name no longer used by the company. Financing came from Cher Wang, the daughter of a Taiwanese plastics mogul and today one the island's richest women, who still chairs the firm's board.

Originally, the plan was to build laptops. But that proved to be a lossmaker. Fortunately the founders had allowed Mr Chou to do his own thing: developing hand-held computers. Earlier than many even in Silicon Valley, he realised that the future belonged to such devices and the mobile internet. As a result, HTC was ready when Western firms came looking for somebody to design and manufacture high-end hand-helds and mobile phones for them. Compaq's iPaq was one of HTC's first products. Now the firm makes more than one in six smart phones sold in America.

HTC could have stayed in this business, which remains profitable. But Mr Chou has looked ahead, and does not like what he sees: shrinking margins. His customers have started to look for rival suppliers in

order to increase their bargaining power. Chinese firms, with their lower labour costs, are pushing into the market. “We need to establish a new competency before we get into trouble,” explains Mr Chou.

In 2006 HTC started to develop its own brand, a far riskier undertaking than it sounds. It was difficult to convince shareholders that change was needed when the firm seemed healthy, particularly in a country where investors focus on the short term and firms have to report earnings every month. The new strategy also meant the loss of much of HTC’s existing business, because some customers did not want to do business with an emerging rival. The corporate culture, meanwhile, had to shift from one focused on efficiently implementing what is decided elsewhere to one that consistently comes up with cutting-edge ideas. And then there is the need for new talent: only by developing designs and software in-house can HTC give products a unique look and feel.

On all these points, HTC has already made much progress. Mr Chou has hired Horace Luke, until 2006 a rising star at Microsoft and the creative director of Windows Mobile, the hand-held version of the firm’s flagship operating system. Mr Luke then created an “innovation infrastructure” of fast-moving development teams, some of which are based in Seattle. Late last year he bought One & Co, a noted design firm based in San Francisco.

Although Windows Mobile is hard to adapt, the firm has delivered three innovative devices based on it, with sales in the millions. HTC was also the first handset-maker to build devices powered by Android, the open-source operating system developed by Google. That has allowed it to introduce distinctive new features to its products. With the Hero, another Android phone, HTC is unveiling a new “experience” called Sense, a user interface that is meant to be more intuitive than the norm. E-mails, text messages, photographs and other files relating to a particular person can all be accessed quickly through the phone’s contact list, without switching laboriously from one application to another.

## Holding out for a Hero

Still, Mr Chou would be the first to admit that HTC does not yet pose much of a threat to the likes of Apple or RIM, the maker of the BlackBerry. Despite the Hero’s qualities, it is unlikely to spawn a “midnight madness”, where people line up at ungodly hours to be among the first to buy a new device. And although Mr Chou professes confidence that HTC can find a place among the world’s top five handset-makers, he also knows that success is not guaranteed. Many other firms have struggled to transform themselves from contract manufacturers into makers of branded devices, including BenQ, a Taiwanese hardware-maker that must loom large in Mr Chou’s thoughts.

That said, he sees no choice but to try. In the long run, he predicts, Taiwanese electronics firms will not be able to compete with their Chinese rivals based solely on the efficiency of their manufacturing operations. “But if HTC can do a good job and set an example in innovation, we can inspire other companies here to try the same,” he says.

**Public-sector pensions**

# Unsatisfactory state

Jul 9th 2009 | LONDON AND NEW YORK
From The Economist print edition

**As workers in the private sector are losing their final-salary pensions, public employees are being shielded from the true cost of provision for old age**

Illustration by Belle Mellor

PENSIONS are expensive to provide. People are living longer, investment returns over the past decade have been dismal and interest rates are low. All this makes a given annual payment costlier to fund. In the private sector, employers are balking at the cost of defined benefit (DB) schemes, in which pensioners are paid a proportion of their final salaries. Many have been shut to new members or discontinued altogether. In Britain, closed DB schemes outnumber open ones by almost three to one.

In the public sector, however, final-salary schemes live on. In part this may be because of a conscious decision to reward workers in vital services such as the armed forces and the police. However, it may also be because the true cost of those pension promises is not being properly allowed for. "Governments are not accounting for what they have promised in the past and are understating what workers are being promised for the future," says John Prior of Punter Southall, a firm of actuaries.

Public-sector schemes face broadly the same costs as private ones. Government employees are living longer, just as private-sector workers are, and their wages are rising too. But the cost is being disguised, not tackled. This has two consequences. The first is that the public sector is building up an immense future liability that the next generation's taxpayers will be required to meet. The second is that public employees are getting a much better deal than their private-sector counterparts—even if the government is not accounting for it. In Britain the gap may amount to 30% of salaries.

Although pension schemes differ from one country to another, many governments are facing similar problems, even if they do not acknowledge them. But the gap between the public and private sectors seems widest in America and Britain. The strain is already beginning to tell. The British government is suggesting that local councils may be given leeway in deciding how fully they should fund their pension schemes. If they had to eliminate their shortfall, taxes could soar. In America, state and local DB plans have seen the assets in their funds lose $1 trillion in value since October 2007.

In Britain some national schemes are "unfunded": that is to say, the government does not put aside a specific pot of cash to meet its liability to its employees. Instead, it vows to meet the cost out of future taxation. Such "pay-as-you-go" schemes, as they are known, are rather like the pyramid schemes made famous by Charles Ponzi, a 1920s swindler, in that they need a continuous stream of new investors to meet the claims of the old ones. (Of course, many basic state old-age pensions work in the same way.)

Other schemes, particularly those on offer from local governments, are funded rather like a company

pension scheme. Contributions from employers and employees go into a pot, which is used to buy assets—shares, bonds and so forth. Over the scheme's life the income from these assets is used to meet the pension payments.

You can quibble about whether there is truly an economic difference between funded and unfunded pensions when, for example, funded American government schemes put money into Treasury bonds. Such schemes still depend on future taxpayers to pay the interest (and repay the capital) on the bonds. There is also something rather odd about the government issuing bonds with one hand and buying them with another—in effect, borrowing from itself. But with a funded scheme it is at least easier to account for the cost.

If a private-sector final-salary scheme runs short of money, it is up to the employer to make higher contributions. In theory the cost may eventually overwhelm the company, which is why both Britain and America have insurance schemes designed to protect workers if employers default. But public-sector pension schemes are generally exempt from the same accounting and regulatory pressures as their private-sector counterparts. In Britain, for example, the Pensions Regulator cannot force the government to top up its contributions, as it can with companies.

That makes it important to account properly for the cost of public-sector pensions. In cash terms, the answer is simple; add up the payments being made to pensioners and subtract the contributions coming in from employers and employees. But that ignores the cost of the promise of future benefits to those still in work. In most schemes, the number of existing and deferred employees (those who have left but are still owed a pension) far exceeds the number of pensioners.

Because these promises fall due only in the future and because $100 now is worth more than $100 in a year's time, they need to be discounted to calculate their present value. The choice of discount rate is crucial. The higher the rate, the lower the apparent size of the liabilities—and the size is highly sensitive to the assumed rate.

What is the right rate? In America the Government Accounting Standards Board requires public DB plans to estimate their liabilities with a rate that reflects the expected return on their assets. The average rate they use is 8%.

Allowing states to use their expected rate of return potentially encourages investment in riskier, higher-yield assets. In a paper last year Robert Novy-Marx and Joshua Rauh, of the University of Chicago, found that if states put their pension assets into a highly geared S&P 500 exchange-traded fund (an extremely risky portfolio), the implied discount rate would yield a "surplus" big enough to pay off all outstanding state bonds and provide a $5,000 dividend to every American citizen.

From an economic perspective, using the expected rate of return makes little sense. The liabilities will not go away if the expected rate of return fails to materialise. Instead, pensions can be thought of as bond-like liabilities, requiring the employer to make a series of payments far into the future. In the private sector, companies are required to discount their liabilities by the yield on AA corporate bonds; the rate reflects the cost of their borrowing and allows for the possibility that the company defaults on its promise.

Although companies may default, it seems odd for a government to make pension promises and then use accounting methods that assume it may fail to keep them. In America, for example, state and local pension benefits are guaranteed by law in many states. That suggests the discount rate should be the Treasury bond yield, considered the risk-free rate.

Mr Novy-Marx and Mr Rauh (who is now at the Kellogg School of Management at Northwestern University) estimated the accrued liabilities of the 116 largest state and local-government pension plans using the risk-free rate. They found the plans were underfunded by $3.12 trillion, more than three times the states' estimate. This figure dwarfs the states' combined municipal debt of $940 billion.

Even on the generous existing accounting basis, the funds look short. Alicia Munnell, director of the Centre for Retirement Research at Boston College, believes that before the credit crunch most public plans were well-funded on that basis—meaning that their assets covered more than 80% of their liabilities. But now she thinks the average plan has a funding level of just 65%.

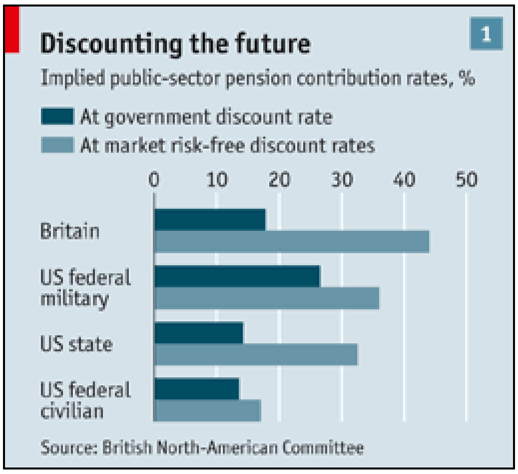
In Britain the vast majority of central-government schemes are unfunded. This includes those covering the National Health Service, the civil service, teachers and the armed forces. The government charges

departments a notional amount each year to cover the increase in future liabilities. In calculating this charge, it uses a discount rate of 3.5% after inflation.

This rate is hard to justify. It cannot be the expected return on assets, since the schemes have no assets to invest. Indeed, when the government calculates the cost of pensions for other purposes, it uses a different rate, which varies from year to year but is now 2.5% in real terms.

Even this may be too high. As a report by the British North-American Committee (BNAC), a group of businessmen, academics and parliamentarians, points out, when a scheme is unfunded, the employer is, in effect, avoiding the cost of borrowing the money to fund the plan. This means the right discount rate should be the cost of government borrowing. The BNAC argues that since British pensions are inflation-linked, the index-linked gilt yield is appropriate. This is only around 1% in real terms.

The BNAC reckons that, on the government numbers, British public-sector pension liabilities are 64% of GDP. At the index-linked discount rate, they are 85%. The difference is even more stark if one calculates how much the government should be charging departments for their pension schemes. At the moment, this charge is 18% of payroll; were it discounting at the index-linked rate, it would be 44% (see chart 1).




Are the BNAC's calculations realistic? Some, including Paul Samuelson, an eminent American economist, would argue that the ability to pay public-sector pensions derives from the power of the government to levy taxes, which in turn is limited by the rate of economic growth. That may be 2-2.5% (real) in Britain, which would produce a much lower figure for pension liabilities than the BNAC estimate. But the future economic growth rate is unknown, whereas the bond yield is set by the market every day.

One test of the pension cost comes from the Bank of England's funded DB pension scheme, which slipped into deficit in recent years. The bank has decided to invest purely in index-linked gilts (so assets and liabilities are matched). Its contributions have risen from 41% to 54% of payroll as it tries to eliminate the shortfall.

Outsourcing of public services creates another useful test. When British workers are transferred from the public to the private sector, their pension rights are shifted with them. The Confederation of British Industry, an employers' organisation, says that private companies find their pension costs are around double those allowed for by the public sector before transfer. The discount rate is not the only reason. Governments also underestimate the longevity of their employees.

In America, the full cost of final-salary pension promises may also be understated. The BNAC report estimates that for all American public-sector schemes (federal and local), the assumed contribution rate by employers is 18% of payroll. If the Treasury yield were used as the discount rate, that would rise to 29%.

## Public versus private

The result of all this is that the total benefits of public-sector workers differ significantly from those of employees in private-sector companies. Around 4.9m British public employees are in open DB schemes, compared with just 1.3m private-sector staff. Around 85% of public employees are members of a pension scheme of some sort, against only 40% in the private sector. Among low-paid employees—earning between £100 ($160) and £200 a week—20% of private-sector workers are in a scheme, compared with 70% in the public sector.

If private-sector workers do get a pension, they are now more likely, especially if they are new to a job, to be in a defined contribution (DC) scheme, where the final pension depends on investment performance. This is clearly more risky from the employee's point of view than a guaranteed proportion of final salary. Furthermore, employers tend to pay in less: around 6.5% of payroll. Although DC employees chip in a further 2.7%, less than the typical contribution of a public-sector worker, that still means the public employee is benefiting from much higher deferred pay (which is what a pension is) than his private-sector counterpart.

The gap is hard to measure because some public-sector schemes are unfunded. But the BNAC estimates that the implied gap in benefit rates is as much as 30% of salary. The Pensions Policy Institute (PPI), a think-tank, using a different discount rate, calculates a gap of between 10% and 30% (see chart 2).

This should be allowed for when private- and public-sector pay rates are compared. In Britain the mean private-sector salary in 2008 was £27,408, against £23,943 in public service. But the mean is inflated by the high wages of investment bankers and so forth. The median public-sector employee is better paid. Once you allow for pension rights, he is even further ahead.

A further disparity is that public-sector workers tend to retire young. The average retirement age for state workers in Ohio is just 57. The normal retirement age for many plans is less than 62, and workers become eligible for retirement at 50. Fire-fighters and police officers often are able to retire with full benefits, sometimes on as much as 90% of their final salaries, before reaching middle age.

Normally, DB plans adjust benefits for early retirement so benefits are lower. But states often limit the size of those benefit reductions. That means taxpayers can subsidise early retirement for public employees. It stands in stark contrast to private-sector workers with DC plans, who will now probably end up working longer than they had anticipated.

## Paying the bill

Trade unions tend to regard such arguments simply as an excuse to attack poorly paid public-sector workers. In Britain the Trades Union Congress points out that the average pension received by ex-local government workers is a mere £4,000 a year. The answer to the disparity between private- and public-sector pensions is to upgrade the former, not downgrade the latter, in the unions' view.

They also regard the question of the discount rate as an accounting chimera. The government does not have to meet its full pension liability upfront. What really counts is the cash cost of meeting pension benefits. The PPI estimates that the cost of paying for unfunded British national schemes will rise from 1% to 1.4% of GDP by 2027-28. That sum involves a lot of guesswork about the future size of the public sector, pay, longevity and GDP growth, but it sounds a lot more manageable than the liability of 85% of GDP cited by the BNAC. Some independent experts, such as John Hawksworth of PricewaterhouseCoopers, an accounting firm, also think the current cost is more important than the present value of the future liability.

Trade unions are also opposed to raising the retirement age for public-sector workers. They feel this is particularly unfair for the lower-paid, who tend to have shorter life expectancy. Indeed, raising the retirement age is far from the whole answer. Benefits would be paid over a shorter period, cutting the cost of a pension, but more benefits would accrue with more years of service, raising it. Mr Rauh estimates that increasing the normal retirement age in America by one year would reduce expected liabilities by just $200 billion, a smallish sum next to the total.

Switching to DC schemes would help reduce costs, although it would be unpopular with employees. Michigan and Alaska are the only states that offer only a DC plan to new staff. Indiana and Oregon require employees to participate in both a DC and a DB plan, and eight states allow a choice between the two types. Even a complete move to DC plans for all future pension entitlements will not reduce the cost of promises already made.

The absence of a painless solution may simply encourage governments to push the bill further into the never-never. The British local-government ministry sent a consultation letter to local authorities last month. In a section headed "a possible new approach to solvency", it suggests authorities may be given "flexibility" about whether even to aim for a funding level of 100%. Private-sector companies are not allowed such flexibility.

Illustration by Belle Mellor

At the last reckoning in March 2007, the assets of British local-authority schemes were reckoned to be worth 84% of liabilities (in present-value terms). Given market movements since then, Watson Wyatt, a firm of actuarial consultants, estimates that the funding level may have fallen to 50-60%. Even repairing that deficit over 20 years would require pension contributions of around a third of council-tax revenues, meaning big cuts in services or big increases in tax. Unsurprisingly these are things the government is anxious to avoid.

In America Norm Jones, an independent actuary, reckons that if the stockmarket does not return to pre-crisis levels in a few years states will have to make big contributions to restore their plans to healthy funding levels. Some may need to receive injections of 50% of payroll. In many states, by law, employees' contribution rates may not be raised, nor their benefits cut. That places the burden on taxpayers.

This will not happen overnight. When states estimate funding levels, they typically take a five-year average of the market value of their assets. They can also amortise their unfunded liabilities over 30 years. So contribution rates will probably not rise until 2011, and then only gradually.

All that is achieved by such machinations is to increase the potential tax bill of future generations—the same generations that will also have to pay higher health-care and pension costs of their own, and meet the interest bills on the government deficits being run up in the face of the credit crunch. It is not much of a legacy.

China and the dollar

# Yuan small step

Jul 9th 2009 | HONG KONG
From The Economist print edition

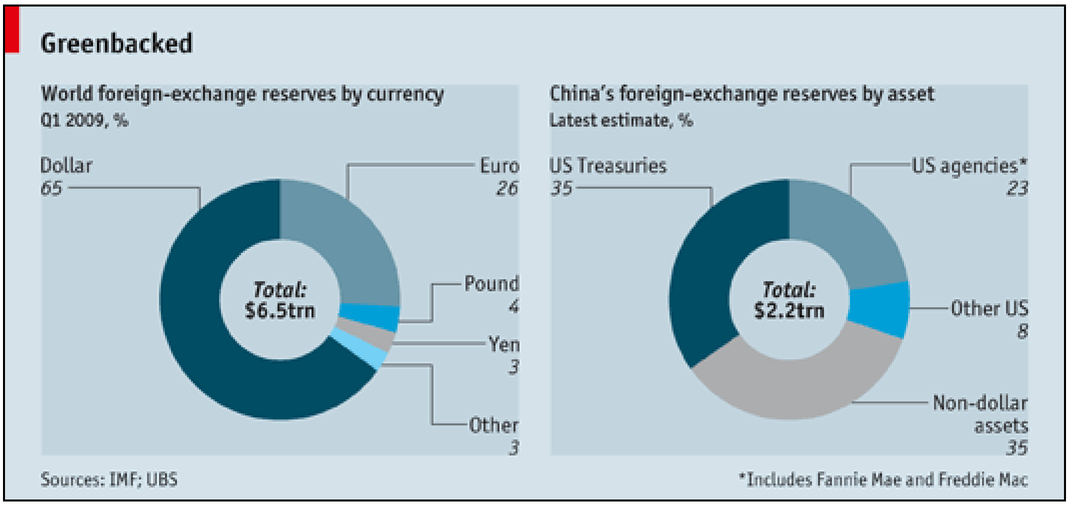
**The dollar's role as the world's main reserve currency is being challenged**

Illustration by S. Kambayashi


THE Chinese used to call dollars *mei jin*, which means "American gold". Buying black-market dollars was considered the safest way to protect one's savings. Yet in June when Tim Geithner, America's treasury secretary, told students at Peking University that China's official holdings of Treasury bonds were safe, the audience laughed. Faith in the greenback is waning.

In the build-up to the annual summit of G8 countries, which began on July 8th in the Italian city of L'Aquila, officials in China, Russia and India all called for an end to the dollar's dominance in the international monetary system. Dmitry Medvedev, Russia's president, declared on July 5th that the dollar system is "flawed"; his central bank has been reducing its dollar holdings. The People's Bank of China (PBOC), China's central bank, repeated its call for a new global reserve currency in June and is now taking the first steps towards turning the yuan into a global currency.

Beijing is particularly influential in this debate. The dollar accounts for 65% of the world's foreign-exchange reserves (see chart), only slightly less than a decade ago and well ahead of the euro's 26% share. Three-quarters of all reserves are in the hands of emerging economies; China alone holds one-third of the global stash.




So China has particular cause to worry that America's massive printing of money in response to the financial crisis will undermine the value of its dollar reserves. There is much domestic anger about the potential losses China may face as a result of its lending to rich Americans. The government would like to diversify out of dollars: its new purchases of Treasury securities have fallen sharply this year. But any attempt to dump its stock of dollars would risk triggering a plunge in the currency. Instead, officials are mulling two ways out of the "dollar trap": persuading the world to adopt a new global currency and encouraging the international use of the yuan.

In an essay in March, Zhou Xiaochuan, the governor of the PBOC, argued that basing the international financial system on a national currency will tend to exacerbate global imbalances. The dollar's reserve-currency status let America borrow cheaply, causing the country's credit and housing bubbles to persist for longer than they otherwise would have. Mr Zhou proposed that the world should replace the dollar with a global reserve currency, the SDR (Special Drawing Rights). Created by the IMF in 1969, and now based on the weighted average of the dollar, euro, yen and pound, the SDR was designed as a reserve currency but never took off. SDRs today add up to less than 1% of total reserves.

Under Mr Zhou's plan the amount of SDRs would be hugely increased and the basket expanded to include other currencies, notably the yuan. Mr Zhou also proposes an SDR-denominated fund, managed by the IMF, into which dollar reserves could be exchanged for SDRs. Countries could then reduce their dollar exposure without pushing down the dollar (although it is unclear who would bear any exchange-rate losses).

Brazil, India and Russia have backed Mr Zhou's proposal. But the SDR is unlikely to become a reserve currency any time soon. It would take years to develop SDR money markets that are liquid enough to be a reserve asset. Although the IMF's executive board approved the first issuance of SDR-denominated bonds on July 1st, as the fund attempts to boost its resources, the bonds can only be bought and traded by central banks, not by private investors.

China's alternative ploy is to promote the yuan's use in international trade and finance. Starting on July 6th selected firms in five Chinese cities are now allowed to use yuan to settle transactions with businesses in Hong Kong, Macau and ASEAN countries. Foreign banks will be able to buy or borrow yuan from mainland lenders to finance such trade. In June Russia and China agreed to expand the use of their currencies in bilateral trade; Brazil and China are discussing a similar idea.

The PBOC has also signed currency-swap agreements with Argentina, Belarus, Hong Kong, Indonesia, Malaysia and South Korea. The central bank will make yuan available to pay for imports from China if these countries are short of foreign exchange. In another recent move, Hong Kong banks are now allowed to issue yuan-denominated bonds, a step towards building an offshore yuan market.

Qu Hongbin, an economist at HSBC, predicts that by 2012 nearly $2 trillion of annual trade (over 40% of China's total) could be settled in yuan, making it one of the top three currencies in global trade. Others reckon this is too optimistic. Although Chinese firms are keen to invoice in yuan, trading partners will be more reluctant. There is no real forward market for the yuan, making it hard to hedge risk, and it is not accepted by most other countries.

The yuan will be used more widely for trade over the next decade but the idea that the yuan can become a reserve currency in the near future is ridiculous, says Arthur Krober at Dragonomics, a research firm

based in Beijing. Not only does China lack the economic and political track record required to underpin a reserve currency, but its currency is not fully convertible. China would need to scrap capital controls so foreigners could invest in yuan assets and then freely repatriate their capital and income, but the government is wary of moving too quickly. A reserve currency also requires a deep and liquid bond market, free from government interference. This, says Mr Krober, implies a big retreat from China's state-led model of credit allocation.

Even if China immediately scrapped capital controls the yuan would be unlikely to challenge the dollar as a reserve currency for years. The dollar did not replace sterling until half a century after America's economy had overtaken Britain's. America's GDP is around three times as big as China's, and its total trade is still larger.

Both the SDR plan and measures to internationalise the yuan also seem to assume that China's problem is simply that too many of its reserves are in dollars. But China's real problem is that it is running a persistent current-account surplus; in order to keep the yuan closely tied to the dollar it has to keep buying more dollar assets. If China really wants to reduce its exposure to the greenback it must allow the yuan to rise. It would incur a loss on its existing reserves but stem future losses. But so long as China maintains its current exchange-rate policy, it is, ironically, helping keep the dollar dominant.

Economist.com FINANCE & ECONOMICS

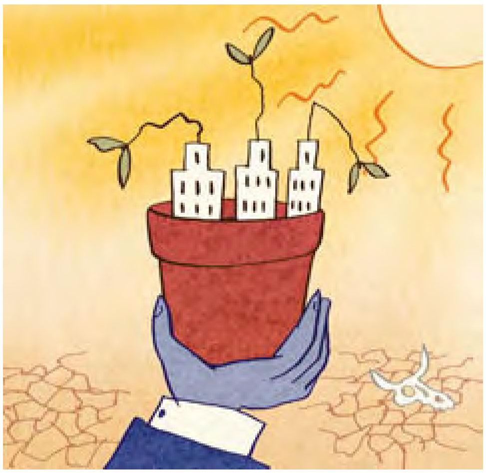
**Buttonwood**

# Testing the model

Jul 9th 2009
From The Economist print edition

**Private equity faces a more hostile world**

Illustration by S. Kambayashi



THE private-equity industry faces a critical test. It prospered in an era when asset markets were generally rising, debt was plentiful and cheap, and recessions were rare and relatively mild.

Now private-equity firms have to manage their portfolios through a recession. They cannot buy companies, strip out costs and "flip" them back to the market or to a trade buyer; there are too few purchasers around. They cannot use as much debt to finance their deals because banks and institutional investors are less willing to finance them. The regulatory climate has also changed. European politicians have seized the chance provided by the financial crisis to propose new rules for the industry, despite the lack of evidence that it had much to do with the credit crunch.

All these changes should provide an answer to a long-running debate about the industry. Is it, as its supporters claim, a superior business model in which the interests of managers and investors are better aligned? Or is it, as its detractors claim, a simple financing ruse designed to allow rich people to take advantage of various tax breaks while simultaneously stripping assets and sacking workers?

Investors may also get answers to some big questions. Is private equity simply a geared bet on equities, offering higher returns but also higher risks? Does an investment in private equity genuinely diversify a portfolio or simply make it less liquid? And does the skill of private-equity managers lie in company selection or in the management expertise they bring to the companies they fund?

There is a potential historical parallel. In the 1960s investors were lured by the appeal of the conglomerate. Smart executives would assemble a portfolio of companies, save costs by sharing group services and use their expertise to allocate capital from head office. But with the admittedly large exception of GE, the dream died. The key driver of conglomerate growth turned out to be a financing trick, in which highly rated shares were used to acquire lowly rated ones, thereby enhancing earnings per share.

Private equity has benefited from the tax deductibility of interest, which gives debt finance an advantage over companies that use equity for the bulk of their capital. Detractors worry that too great an expansion of the private-equity model would weaken the corporate tax base and, by making companies more fragile, cause recessions to be either more frequent or more intense when they occur.

A new academic study of buy-out failure rates from Leeds University and Nottingham University comforts that: "For any given amount of leverage, if a company is private-equity-backed or not, it is no higher risk than others." But that is an odd statement. First, the leverage is the whole point. The objection to private-equity firms is that they load companies with more debt than other businesses; the issue is whether the typical private-equity-backed company goes bust more often than other firms in its sector. Second, what about the argument that private equity is a superior business model? If that were true, the companies the industry funds should go bust less often.

The business-model argument runs as follows. Allow the managers to take charge of a company, motivate them properly with share options and it is amazing how they find the scope to eliminate costs and improve the business. Of course, it is the cutting of costs that the detractors worry about. A study by Josh Lerner for the World Economic Forum in 2008 found that firms run by private-equity groups shed more jobs than their peers in the two years after a buy-out, although the differences disappear after

that. The corollary is that productivity improves at companies that have undergone a buy-out.

The problem for the industry now may be that every company is trying to cut costs in a recession. Highly leveraged companies will find the pressure most intense. Many of the businesses that the sector financed in the heady days of 2006 and early 2007 are struggling. And companies that emerge best from recessions tend to be those with the balance-sheet strength to invest and grab market share.

This suggests that the industry may be due a period of contraction, rather like the one the hedge-fund industry has suffered over the past 18 months. Those firms without any management skills will be weeded out. Investors will demand lower fees from those that remain. And every private-equity-backed company that fails will be cited as evidence for the prosecution by hostile politicians.

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Economist.com/blogs/buttonwood

**Reforming finance: Bank capital**

# Target practice

Jul 9th 2009
From The Economist print edition

**How much capital is enough? The second in a series on financial reform**

ASKING how tight gun-control laws would need to have been to have prevented any assassinations in Sarajevo in 1914 is not a rewarding exercise. For banks, however, looking at “what if” scenarios is more worthwhile. Most regulators now think that gradually building up capital buffers as the economy recovers is the best way to make banks safer. Britain’s Treasury was the latest to tread this line in a white paper unveiled on July 8th.

For a long time the amount of capital required to withstand a genuine meltdown has been a near-complete unknown. The minimum capital levels set by the Basel 1 accord in the late 1980s in effect endorsed the overall amount of capital in the system at that point. The crisis changes all that. Estimates of ultimate losses remain highly uncertain and the state of the economy is unclear. But regulators now have a real-life example of a systemic collapse with which to calibrate their new rules.

So how much capital would the system have needed to have survived the crisis unscathed? It depends how you define “unscathed”. Assume, in an ideal world, that no bank should be in the position of having to raise equity once a crisis has begun. And assume, too, that at no point in the cycle should its level of core capital (basically, its common equity) drop below the minimum now demanded by the American and British governments of 4% of risk-weighted assets.

Based on the estimates used in the American government’s stress tests, the 19 firms involved collectively need to hold minimum core capital of $313 billion. Between the start of the crisis in mid-2007 and the end of 2010, these firms are expected to eat up about $317 billion of capital (with gross losses of almost a trillion dollars offset by core earnings). On this basis, they would need to have entered the crisis with $630 billion to have avoided breaching the floor. That is equivalent to 8.1% of their current risk-weighted assets. The American and European systems actually had a core-capital ratio of nearer 6% at the end of 2007, according to the Bank of England. The Basel rules allowed core-capital ratios to go as low as 2%.

If anything this calculation is generous. Using Bloomberg’s higher estimates of the losses recorded so far, a peak core-capital ratio of nearer 10% would have been needed for the big American banks. And of course losses are not evenly distributed across the system. Citigroup would have needed a starting core-capital ratio in the mid-teens. Using a similar methodology, Switzerland’s UBS would have needed a pre-crisis ratio of about 12% to have avoided hitting the floor of 4%. This is not far off the level it actually had. The fact it has still raised so much equity reflects a tough regulator and the perception that to command the confidence of its private-banking customers, its minimum core-capital must always be far above the 4% level.

That points to one problem with the exercise: a 4% minimum at the bottom of the cycle may be too low. There are others. Estimates of losses will be wrong. Bulls point to the recovery in the prices of risky assets such as leveraged loans. Bears worry that unemployment will rise above the level assumed in the stress tests. There is also a risk of double-counting. The adjustments used to calculate risk-weighted assets are becoming more conservative, as regulators seek to penalise certain types of activity, especially trading. That will also have the effect of building up capital, even if the minimum ratio remains unchanged.

Still, for all these caveats, the basic message seems pretty clear. Going into another crisis of this scale, absolute capital levels would need to be at least double the existing minimum level to avoid breaching that floor at the trough of the cycle. If regulators think the worst banks should set the benchmark for all in the future, the buffer could be even higher. For banks, that is bad news. Their best chance is to persuade regulators that a repeat is unlikely, but such pleading may fall on deaf ears. Right now, governments are interested in stitching taxpayers a bulletproof vest.

**Modifying delinquent loans**

# Mortgage mistakes

Jul 9th 2009 | WASHINGTON, DC
From The Economist print edition

**America’s foreclosure-prevention strategy may be misconceived**

AP


**Writing on the wall**

AMERICAN policymakers have long held that mortgage modification is one of the best ways to tackle the country’s housing bust. The logic is alluring. Since foreclosures are costly for lenders as well as painful for borrowers, both sides could be better off by renegotiating a mortgage. The sticking-point, according to conventional wisdom, is securitisation. When mortgages are sliced into numerous pieces it is far harder to get lenders to agree on changing their terms. Hence the need for government action.

It is a compelling argument, but apparently not an accurate one. A new study* by a trio of Federal Reserve economists finds that very few delinquent mortgages are modified overall, and that securitised loans are as likely to be renegotiated as those on lenders’ books.

The economists looked at a sample of mortgages in a huge data set that covers 60% of America’s residential-mortgage market. Less than 3% of seriously delinquent borrowers got a mortgage modification that reduced their monthly payments in the year after they got into trouble. Less than 8% of them got any kind of modification at all. Differences between securitised mortgages and others were scant. Lenders of all stripes clearly prefer to foreclose on delinquent borrowers. Repossession proceedings were begun in half the cases and completed in one-third of them.

Why are lenders so reluctant to renegotiate? One reason is that it often fails. Almost half of renegotiated loans are delinquent again within six months. And when house prices are falling, to delay foreclosure means taking a bigger loss.

The study also suggests a second reason for the reluctance to renegotiate. Almost one-third of seriously delinquent borrowers “self cured” within a year. They either paid off their mortgages or caught up on their payments. Had lenders renegotiated with these people they would have lost money unnecessarily.

These results have intriguing implications. The high “self cure” rate suggests that lots of people are temporarily delinquent, perhaps because they lose their jobs or fall sick. The government could help these people by temporarily paying part of their mortgages. At the other extreme, the high rate of redefault suggests that mortgage renegotiation only puts off the inevitable for many borrowers. In these cases public policy would do better to streamline foreclosure than try vainly to prevent it.

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* “Why Didn’t Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures and Securitization”, by Manuel Adelino, Kristopher Gerardi and Paul S. Willen. FRB Public Policy Discussion Paper No 09-4.

**Venture capital in America**

# The brightest and the rest

Jul 9th 2009 | SAN FRANCISCO
From The Economist print edition

**Too much money has been chasing too few great start-ups**

ONE of Silicon Valley's biggest success stories is doing his bit to lift the gloom hanging over America's venture-capital (VC) industry. On July 6th Marc Andreessen, who made his name in the 1990s as the co-founder of Netscape Communications, the firm behind one of the earliest web browsers, announced that he and a partner, Ben Horowitz, had raised $300m to back promising start-ups. The fund was heavily oversubscribed and attracted money from several other tech luminaries.

His is not the only glimmer of light. On July 9th the latest results from a "confidence index" compiled by Mark Cannice of the University of San Francisco showed that venture capitalists had become more bullish for the second consecutive quarter. The comatose market for initial public offerings (IPOs), an important exit route for VCs looking to unload companies, is also showing a few signs of life. According to Thomson Reuters and the National Venture Capital Association (NVCA), an industry group, there were five venture-backed IPOs in the second quarter of 2009, worth a total of $721m.

Yet the worst is far from over. The downturn has battered many start-ups, forcing their backers to pump in more cash to keep them afloat. The dire state of the IPO market and the mergers-and-acquisitions business means VC funds will have to hold on to firms for far longer than planned. This will almost certainly lead to a dramatic reshaping of the industry. Mr Andreessen reckons that as many as 300 of the 880 or so active funds in existence could disappear. Observers are on the lookout for "zombie funds", which keep their existing investments ticking over until they mature but stop making new ones.

The NVCA is lobbying hard for changes that it thinks will revive the IPO market. Among other things, it argues that a new generation of small investment banks is needed to support venture-backed offerings. "We can't sit around and wait for the big banks to come to us," explains Dixon Doll, a former chairman of the NVCA. The group also wants regulators to reduce the compliance burden on small firms thinking of going public.

But the proposals fail to address the root cause of the industry's problems, which is that most venture capitalists have failed to find enough decent companies to deliver the returns they promised investors. A recent report by Paul Kedrosky of the Ewing Marion Kauffman Foundation, a research outfit devoted to entrepreneurship, points out that ten-year VC returns will turn negative at the end of this year as the big wins from the dotcom era fade away.

The problem is that although many venture capitalists have been outstanding at raising cash, they have been pretty lousy at investing it. Even after the dotcom bust, endowments, pension funds and rich families fell over one another in a rush to back funds they hoped would produce the next Google or Genentech. "Everybody and his brother jumped into the business," says Navin Chaddha of Mayfield Fund, a big venture firm. As a result VC funds have been investing, on average, a whopping $26 billion a year in start-ups since 2004.

But much of the money has ended up in me-too companies that will not become the shining stars venture funds so badly need. All that cash has also inflated valuations of fledgling businesses, making it harder for VC funds to turn a profit on them. Many reckon the industry needs to become substantially smaller. Fred Wilson, a venture capitalist who pens a blog on the industry, has estimated that the amount invested each year needs to fall to around $15 billion-17 billion in order to produce acceptable overall returns. Mr Kedrosky puts the figure at $12 billion.

Investors are already tightening their purse strings. According to the NVCA, venture funds raised a total of $4.3 billion in the first three months of the year, compared with $7.1 billion in the same period of 2008. Only three new funds were launched in the first quarter of this year, compared with ten and 21 in the same period of 2008 and 2007 respectively.

Even existing funds will find it hard to raise fresh capital unless they are at the very top of the industry's pecking order. Josh Lerner, a professor at Harvard University, points out that the top 10-15% of funds have generated a large percentage of the industry's total returns over time, partly because of their experience but also because their reputations make them a magnet for top entrepreneurs. So investors are still likely to compete for a slice of funds run by the likes of Sequoia Capital and Benchmark Capital, two industry leaders.

Does all this mean that Mr Andreessen's timing is off? Not necessarily. For one thing, his extensive network in the Valley—where he sits on the boards of Facebook and eBay—means he should be able to tap into some of the brightest minds around. For another, funds raised during a recession tend to outperform those created during booms, perhaps because there is less competition around for portfolio companies. It makes sense for Mr Andreessen to enter the VC business when his peers are heading for the exit.

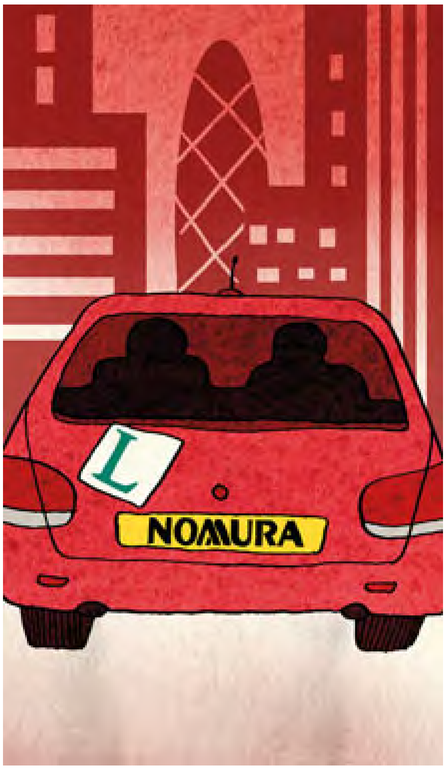
**Nomura's integration of Lehman**

# To "L" and back

Jul 9th 2009 | LONDON AND TOKYO
From The Economist print edition

**Nomura beds down its high-profile acquisition. Now for the hard part**

Illustration by S. Kambayashi




LAST year, shortly after Nomura had taken over Lehman Brothers in Europe and Asia, staff of the Japanese investment bank wandered through the trading floors of its new acquisition in London stripping the Lehman name from walls and desks. There was not much they could do about the racing-green carpets, however much they recalled the era of Dick Fuld.

This week Nomura finally pulled the rug from under the Lehman legacy when it made clear it would abandon its Canary Wharf tower in favour of spacious new digs in the City of London. The decision coincides with a new marketing slogan, "Just say Nomura". Japanese chicken *katsu* curry has appeared on the canteen menu. Ex-Lehman executives are fined in meetings if they mutter the "L" word.

To the Nomura faithful, this is all part of a "hearts and minds" campaign to sow loyalty among the 8,000 flinty Lehmanites the bank acquired last year. Nomura is desperate to prevent the best of them walking out next year when up to $2 billion-worth of guaranteed pay packages run out.

The ex-Lehman old guard mocks such blandishments. To them, the thing that counts is success—and remarkably, they concede, there is some. Nomura's equity-trading business has vaulted from nowhere to become the third-biggest on the London Stock Exchange (Lehman used to be number one). The fixed-income business is not saddled with the legacy assets plaguing most of its peers. Nomura is the first Asian bank to have secured a trading licence in Saudi Arabia.

Even investment banking, where customers may be most picky about a Japanese novice, has won some competitive mandates, such as a role in June's £530m ($850m) leveraged buy-out of Wood Mackenzie, an energy consultancy. It may yet be involved in a putative mining merger between Xstrata and Anglo American.

All this may mean a pleasant first-quarter earnings surprise later this month. After Nomura's disastrous 709 billion yen ($7.2 billion) loss in 2008 that would strengthen Kenichi Watanabe, Nomura's boss, against a board in Tokyo that has its doubts about his Lehman deal. "This has been the most remarkable nine months," says Sadeq Sayeed, Nomura's European chief. "There are no integration issues left."

It is one thing to bed down Lehman's European operations. It is another to build a top-five global investment bank to match Goldman Sachs or JPMorgan. And that is where Mr Watanabe's ambitions may lead to a new spate of battles between Tokyo's entrenched hierarchies and the hard-nosed Lehman pragmatists.

Challenge number one is financial. Nomura, which has a huge distribution network in Japan, sees itself principally as an Asian version of Merrill Lynch. It funnels Japanese equity and debt to wealthy nationals, and does some M&A work. It does not have a big balance-sheet. Lehman, by contrast, grew (and ultimately collapsed) by aggressively punting its own cash. Although Lehmanites admit the firm held on to assets for too long, they believe clients will continue to demand massive financial support for takeovers, capital-raising and derivative deals. Unless Nomura merges with a money-centre bank, such as, say, Japan's Mizuho, some worry that it will lack the muscle for the big league.

To reach the top it will also need a stronger presence in America. But securing a foothold there will be costly and may further unnerve Nomura's board. That is why the second big battle could be over the appointment of a Western investment banker into a position of real authority. At present no ex-Lehmanite is on Nomura's two most senior boards, and the rigid pecking order makes it hard for other voices to be heard—especially those from London.

It seems too much to hope that the Tokyo hierarchy will be dismantled soon—not least because the ex-Lehmanites, for all their talents, have a very blotted copybook. But after Mr Watanabe did the deal last year, he told *The Economist* he hoped it would lead to the "transformation" of Nomura. Real change often starts at home.

**Trade compression**

# Number crunch

Jul 9th 2009
From The Economist print edition

### The CDS market has shrunk dramatically. Why?

EVEN in a crisis full of big numbers, the size of the credit-default-swap (CDS) market, which stood at a monumental $57 trillion dollars in June 2008, has grabbed attention. That number has since shrunk dramatically. According to the Bank for International Settlements, the value of outstanding CDS contracts had fallen to $42 trillion in December.


The apparent collapse is largely down to something called trade compression. Since August, credit-derivative dealers have been routinely giving details of their CDS trades to compression vendors. These companies propose new sets of CDS contracts that keep each of the participating dealers' net positions the same, but aggregate them into far fewer contracts. Unlike netting, which only hides contracts, trade compression excises them completely, cutting down the possibility of legal wrangling and reducing counterparty risk.

CDS sceptics cannot breathe easily yet. Room for further compression is diminishing. In 2008 TriOptima, a big vendor, compressed over $30 trillion of credit derivatives; that number fell to $9 trillion in the first half of 2009. And the benefits of compression have been felt mainly in the index market, where traders buy protection against a pool of different firms. Figures from the Depository Trust & Clearing Corporation, which has details on a majority of CDS trades, show that the value of the market for index CDSs has fallen by almost 40% since October (see chart); the number of outstanding contracts has almost halved. The riskier market for single-name CDSs, where dealers can bet on the chance that individual companies will fail, is less standardised and less easy to compress. It has edged up by 7% since January.

## Economics focus

# Walk, don't run

Jul 9th 2009
From The Economist print edition

**In a guest article Justin Lin, the chief economist at the World Bank, argues that low-income countries need to make small, local banks the mainstay of their financial systems**

Reuters

FIXING finance is easier if you have a clear idea what it is for. What matters most is setting up a financial sector that can serve the competitive sectors of an economy. In many poorer countries, that means focusing on activities dominated by small-scale manufacturing, farming and services firms. The size and sophistication of financial institutions and markets in the developed world are not appropriate in low-income markets. Small local banks are the best entities for providing financial services to the enterprises and households that are most important in terms of comparative advantage—be they asparagus farmers in Peru, cut-flower companies in Kenya or garment factories in Bangladesh.

The experiences of countries such as Japan, South Korea and China are telling. Those countries managed to avoid financial crises for long stretches of their development as they evolved from low-income to middle- and high-income countries. It helped greatly that they adhered to simple banking systems (rather than rushing to develop their stockmarkets and integrate into international financial networks) and did not liberalise their capital accounts until they became more advanced. The experience of the United States is also instructive. Hulking national banks and equity markets become important only when a country becomes more advanced and when large capital-intensive firms dominate the economy. The rise of the New York Stock Exchange occurred only after the creation of large-scale industrial firms at the close of the 19th century. For the early labour-intensive phase of America’s economic development, local banks were dominant.

Governments and the international financial institutions that help them should resist the temptation to strive for “modern” stockmarkets in the early stages of a country’s development. Efforts to create African stockmarkets, for example, have not yet borne much fruit. There are relatively few listed shares in the stockmarkets of sub-Saharan countries. Excluding South Africa, the annual value of traded shares relative to GDP in Africa is below 5% (see chart). In Latin America and the Caribbean the figure is less than 10%; in the former communist countries of Europe and Central Asia it is less than 15%. The comparable figure in 2007 was 79% in Denmark, 207% in Spain and 378% in Britain.


Stockmarkets are unlikely to be a major force in poor countries in the near future. Microfinance companies and other non-bank financial institutions will play a more important role in financing poor households. And stockmarkets are not the best conduit for providing finance to the small- and medium-sized businesses that characterise the early stages of countries' economic development. Instead, the banks will be much more critical when it comes to financing companies.

But gigantic banks are not the way to go. In Africa and other parts of the developing world, relatively large foreign banks that were set up in the colonial era have long played a role. But these institutions tend to serve relatively wealthy customers. Smaller domestic banks are much better suited to providing finance to the small businesses that dominate the manufacturing, farming and services sectors in developing countries. There is evidence to suggest that growth is faster in countries where these kinds of banks have larger market shares, in part because of improved financing for just these kind of enterprises.

It is true that bigger banks can exploit economies of scope and scale that make them more diversified, thus enhancing systemic stability. But local banks are stable in a different way. In America the country's 7,630 community banks have so far been only mildly affected by the financial crisis as they have continued to deal with the same small, local clients that they have had for years.

Governments in low-income countries should recognise the strategic importance of small, private domestic banks. They should also carry out some fundamental reforms. On the demand side of the equation, entrepreneurs in developing economies need to be able to signal more easily that they are creditworthy. Sustained efforts to improve credit and collateral registries offer large pay-offs. Credit registries enable first-time entrepreneurs to document their personal credit histories and share them with lenders. Collateral registries enable lenders to verify that assets such as property and vehicles have not already been pledged by the borrower to secure past loans. Transparent and efficient court procedures allow lenders to seize collateral in the event of loan defaults.

## Step changes

On the supply side, underachieving banks, be they large or small, should be rooted out through merger or liquidation. In many developing countries, supervisory authorities find it difficult to intervene and dispose of troubled banks' assets quickly. Supervisors in some countries face legal challenges from the owners of such banks, sometimes long after they have left office. All this impedes the efficient exit and entry of institutions that make for a vibrant local banking sector. Failing local banks should be acquired by stronger local banks or liquidated if no such purchaser can be found. After liquidations well-capitalised new banks should be allowed to enter the sector.

Facilitating the creation of new local banks and improving the methods for intervening to deal with troubled banks will encourage competition and provide healthier incentives. That will help banks promote the private-sector-led growth that will be crucial to recovery from the current financial crisis. Leave the developed markets to worry about how to reform their highly evolved financial systems. To make sustained progress in lifting the weight of the extreme poverty that will remain after the crisis has subsided, low-income countries need to make their financial institutions small and simple.

For a discussion of this article, visit Economist.com/freeexchange

**Extending lifespan**

# Of mice and monkeys

Jul 9th 2009
From The Economist print edition

**And men?**

Illustration by Claudio Munoz

MOST people accept that death and taxes are inevitable. But that doesn't mean you should not try to postpone them. A good accountant can help with the latter, but the usual prescription for the former is a way of life that avoids excess.

That advice might be even truer than many of its proponents realise, for it has long been known that restricting the diets of several species of laboratory animal seems to slow down the process of ageing. This is a question not just of avoiding obesity, but of reducing an individual's intake of calories to a point significantly below normal consumption—almost, but not quite, to the point of malnutrition. At the same time, some drugs are also known to have anti-ageing properties—again, in "lower" animals. It is therefore good news for potential Methuselahs that both these approaches have now been brought closer, phylogenetically speaking, to humanity.

Caloric restriction, as the dietary method is properly known, was tested by Richard Weindruch and his team at the University of Wisconsin using rhesus monkeys— the workhorses (to mix literal and metaphorical livestock) of laboratory studies on non-human primates. Previously, the nearest species to a human for which caloric restriction had been proved to work was a mouse. Dr Weindruch's results are published in this week's edition of *Science*.

Meanwhile that publication's rival, *Nature*, has a report by David Harrison of the Jackson Laboratory in Maine and his colleagues on the life-prolonging effects of a drug called rapamycin. In this case the experiment was done on mice. But that is much closer to humans than the nematode worms and fruit flies which were the subjects of previous successful experiments on drug-induced life extension.

## No pain, no gain

One reason why primates have not been the subject of anti-ageing studies until now is that they live so long anyway. Dr Weindruch's paper is the result of 20 years of work. Over the course of that period he and his team have looked at 76 monkeys (30 males to start with and, since 1994, another 16 males and 30 females). Half these animals were kept as controls, with no changes in their diet, and the other half

experimented upon.

Each animal in the experimental group was observed for up to six months to find out how much it ate when food was freely available. It then had the calorific value of this baseline diet cut, in three monthly tranches, until it had been reduced by a total of 30%.

The upshot is that, so far, 14 of the 38 control animals have died of age-related illnesses such as type II (late onset) diabetes, cancer and heart disease. Only five of the experimental animals so succumbed. A statistical analysis showed that, at any given time during the study, an animal in the control group was three times as likely to die from an age-related cause as one in the experimental group.

Not all of the animals that died did so from age-related conditions. Some succumbed to injury, infection and even complications from anaesthesia. But when it came to these more random deaths, both groups suffered almost equally. Seven went down in the control group, and nine in the experimental one. An apparent win, then, for caloric restriction—though it will not be possible to say for sure until all members of both groups have died and the extra years of life (if any) of the experimental subjects can be known precisely.

Semi-starvation is not, however, a course of action most people would be willing to undertake in the hope that it might prolong their lives. But they might be willing to take a pill. Indeed, a company called Sirtris Pharmaceuticals is already running trials of drugs that affect proteins called sirtuins—a group of enzymes which experiments on invertebrates have shown to be involved in extending lifespan.

Dr Harrison and his colleagues picked a different molecule that has been seen to work on invertebrates: rapamycin. This substance, isolated originally from a strain of bacterium found on Easter Island—or Rapa Nui as it is known to the locals—acts by suppressing a particular signalling mechanism inside cells, called the TOR pathway. The TOR pathway, in turn, promotes protein production and inhibits the active destruction of parts of cells that are no longer needed. Slowing down all this molecular turnover seems to slow ageing, at least in worms and flies. So Dr Harrison’s team decided to give it a go in mice.

## Easter eggs

Laboratory mice, which have no predators other than the white-coated variety, live for a maximum of just over 1,000 days. The researchers started feeding them with rapamycin at the age of 600 days—about the same point in their lives as a 60-year-old human has reached. The results were impressive. Maximum female lifespan increased from 1,094 days to 1,245, though males did somewhat less well, going from 1,078 days to 1,179. Measured from the time the drugs were first administered in early old age, these figures translate into a 38% increase in life expectancy for females and 28% for males.

What is equally interesting is that both the TOR pathway and the one controlled by sirtuins are also affected by caloric restriction. It looks, in other words, as if the drug-based and diet-based approaches are acting in similar ways. That is not to recommend people take doses of rapamycin. Its main medical use is to suppress the immune system, so anyone consuming it casually would open himself to serious infection. But it does hold out the tantalising hope that, at some point in the future, it might be possible to pop a pill and put an extra decade or two on your life.

Encouraging competitiveness

# Psyched out

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From The Economist print edition

**The fewer the competitors, the harder they try**

Alamy

**Calculate the answer when n approaches infinity**

WHAT relationship there is between the number of participants in a competition and the motivation of the competitors has long eluded researchers. Does the presence of a lot of rivals stimulate action or lead someone to give up hope? It is more than an academic question. Or, rather, it is a very academic question indeed, for it may affect the way that examinations are conducted if they are to be a fair test for all.

To investigate the matter two behavioural researchers, Stephen Garcia at the University of Michigan and Avishalom Tor at the University of Haifa in Israel, looked at the results of the SAT university entrance examination in America in 2005. This test generates a score supposedly based on the test-taker's verbal and analytical prowess.

The two researchers used data on the number of test-takers in each state of the union and the number of test-taking venues in that state to calculate the average number of test-takers per venue in the state in question. They found that test scores fell as the number of people in the examination hall increased. And they discovered that this pattern was also true for the Cognitive Reflection Test, another analytical exam.

These results are intriguing, but lend themselves to more than one explanation. To find out whether they were caused by a psychological effect related to the number of perceived competitors, or were merely a consequence of the greater distraction produced by crowding more people together, Dr Garcia and Dr Tor conducted an experiment. They asked 74 university students to take a timed, easy general-knowledge quiz which they were asked to finish as quickly as possible without compromising accuracy. Each student completed the test alone, but half were told they were competing against ten other people and the other half that they were competing against 100. All were informed that those whose completion times were in the top 20% would receive $5.

The results backed up the psychological hypothesis. Students who believed they were competing against only ten people finished in an average of 28.95 seconds. Those who believed they were competing against 100 averaged 33.15 seconds.

Curious as to why mere belief that he was facing more competitors would alter an individual's performance, the two researchers ran a second experiment. They asked students to imagine they were running a five-kilometre race against 50 people and then against 500 (or, in half of the cases, the other way round). In both notional races the top 10% of competitors would get a $1,000 prize. The researchers told the students to rate, on a seven-point scale, how much faster than normal they would run in each notional race, with a one being slightly faster than normal and a seven being the fastest of their lives.

The average value in the competition against 50 others was 5.43; in the competition against 500 it was 4.89—a result consistent with the other two parts of the study.

When that bit of the test was over, Dr Garcia and Dr Tor then asked the participants a series of questions commonly used by psychologists to evaluate an individual's tendency to compare himself with others in a social environment. They found that those with the highest tendency to make such comparisons had the lowest scores in the notional race against 500 others. These socially aware individuals are, as it were, looking around, assessing the situation and thinking that it is not worth trying too hard.

In their report on the matter in *Psychological Science*, Dr Garcia and Dr Tor dub their discovery the "n-effect" since "n" represents any numerical value in mathematics. If confirmed, it may mean not only that examination halls should be kept small— or, at least, the same size for all participants so that the playing field is level—but also that other competitive activities should be scaled down for best results.

Sex ratios and maternal environment

# Sons and mothers

Jul 9th 2009
From The Economist print edition

### Poor circumstances breed daughters

Panos

THAT mother knows best is no secret. That her reproductive organs also know best may come as more of a surprise. But that is what two evolutionary biologists, Robert Trivers and Dan Willard, hypothesised nearly four decades ago. Boys, they reasoned, will thrive reproductively when they have grown big and strong in resource-rich environments. Otherwise, they will do badly. Girls, by contrast, will do reasonably well across the board and thus have a comparative advantage over their brothers in poorer situations. Parents, meanwhile, have a genetic incentive to see their progeny do well. Give a mother abundant resources, then, and her body should favour sons. Place her in difficult conditions and she should have more daughters.

The Trivers-Willard theory has been tested with success in several species of wild animal. Showing it to be true in people, however, has proved difficult. But a paper just published in *Biology Letters* by Thomas Pollet of the University of Groningen, in the Netherlands, and his colleagues makes a brave attempt to do so. Dr Pollet tests it by studying polygamous households. As wives are added to such a household, its resources will necessarily be split more ways. Even if they are shared equally, the first wife will have had a head-start on the others—and, life being what it is, she may retain a dominant position.

Much of the world has given up open polygamy, of course (though the discreet sort remains common everywhere). It is, however, still practised in parts of Africa. Dr Pollet and his colleagues therefore turned to Rwanda, and used data gathered in a census of that country taken in 2002.

They found 96,880 married women who reported having children. They classified the marriages in question as either monogamous or polygamous. The wives in polygamous marriages were further classified as either “first”, “second” or “third or lower order”. As the researchers suspected, when all other things were equal mothers in monogamous marriages had most sons: 101 for every 100 daughters. Those who were the first wives of polygamists scored similarly. Wives who were “third or lower order”, though, had only 94 sons for every 100 daughters.

Of course, all other things are rarely equal. The team also found and corrected for the facts that a mother’s age and which province she lived in affected the sex ratio of her children. Her level of education, whether she lived in a town or the countryside, and whether she owned the house she lived in did not, however, seem to make any difference (not that a lower-order wife is ever likely to own a house).

What the researchers did not correct for was the father’s age. And previous studies have shown that older fathers are relatively more likely to beget daughters. So part of the effect Dr Pollet has discovered might be caused by the fact that, obviously, a man is older when he takes a second or subsequent wife than when he marries for the first time. This age effect, too, could be ascribed to the Trivers-Willard hypothesis if, say, sperm quality falls with age. But it would be a separate phenomenon from what is going on in the mother.

If that confounding variable can be taken care of, though, and the effect persists, the next obvious step is to determine what mechanism within the mother’s body causes the discrepancy. The Y-chromosome, which carries the genes for maleness, comes from the father, so it cannot be the case that the mother is failing to ovulate “male” eggs. It seems most likely that potential sons are failing to implant in the wall of the womb, and so never get the chance to develop.

Solar power and the Sahara desert

# The start of something big?

Jul 8th 2009
From The Economist print edition

**Solar electricity may be about to attract real money**

IT IS an old idea. Build solar power stations in the Sahara desert and transport the electricity produced to Europe using high-voltage, direct-current (HVDC) cables. It is simple in theory, but hard in practice—and very, very costly. But it is a carbon-dioxide-free way of making a lot of electricity, and a collecting area the size of Austria could supply the world.

A meeting on July 13th might get the ball rolling. Munich Re, the world's largest reinsurance company, has invited 20 large companies (including Siemens, Germany's engineering giant; power suppliers RWE and E.ON; and Deutsche Bank, Germany's biggest) to join it in forming a consortium called Desertec. If all goes well, this will eventually build a legion of solar power stations in Africa and Arabia, and connect them to Europe.

The power stations in question will be "solar thermal", rather than the better known sort relying on photovoltaic solar cells. In other words, instead of converting the sun's rays directly into electricity using expensive semiconductor-grade silicon, they will use cheap metal mirrors to focus those rays either onto boilers that make steam to drive turbines, or onto containers of special low-melting-point salts that will store heat overnight, so that it is available to drive turbines during the hours of darkness.

Munich Re's interest in the matter is to reduce the effects of global warming. "Climate change affects our core business of weather-related natural catastrophes," says Peter Höppe, the head of the firm's "geo risks research" department. Munich Re hopes that introducing solar power on a large scale will at least slow the process down a bit.

Large-scale investment would also provide economies of scale and stimulate innovation, thus reducing the cost of solar electricity. At the moment, no form of solar power is as cheap as coal-generated electricity, but solar-thermal is reckoned by many to be a better bet to get there than photovoltaics—a task that is also made easier by the extra cost of the permits to emit carbon-dioxide that the European Union now requires the operators of coal-fired power stations to hold.

If the scheme were implemented in full, it would involve spending €400 billion ($560 billion) at today's prices, over the next 40 years, building enough solar power stations to satisfy 15% of European demand in 2050—together with most of North Africa's and Arabia's—and about 20 trans-Mediterranean HVDC cables which, unlike conventional AC power lines, can transmit power over long distances and through water without significant losses. A bold proposal, then. But not a completely outrageous one. As the old Chinese proverb has it, even a journey of 1,000 miles begins with a single step.

China's future

# Enter the dragon

Jul 9th 2009
From The Economist print edition

**The West hopes that wealth, globalisation and political integration will turn China into a gentle giant. A new book argues that this is a delusion**

Ronald Grant Archive

**When China Rules the World: The Rise of the Middle Kingdom and the End of the Western World**. By Martin Jacques. *Allen Lane; 592 pages; £25. To be published in America by Penguin Press in November.* Buy from Amazon.co.uk

THERE have been many rivals for America's crown as the world's greatest power. In the 1950s the Soviet Union threatened its military hegemony; in the 1980s Japan challenged its economic might. These days the pretender is China. The evidence of America's decline seems obvious. The limits of its military power were exposed after the invasion and occupation of Iraq, and the flaws of its capitalist system were revealed by the global financial crisis that started on Wall Street. The West now looks to China to prop up its financial system, and to the Chinese consumer to stimulate the global economy.

Is the long era of Western dominance, first by European powers and then by America, finally coming to an end? For Martin Jacques, a British commentator and recently a visiting professor at universities in China, Japan and Singapore, the answer is clear. The title of his book says it all: "When China Rules the World".

He begins by citing the latest study by Goldman Sachs, which projects that China's economy will be bigger than America's by 2027, and nearly twice as large by 2050 (though individual Chinese will still be poorer than Americans). Economic power being the foundation of the political, military and cultural kind, Mr Jacques describes a world under a Pax Sinica. The renminbi will displace the dollar as the world's reserve currency; Shanghai will overshadow New York and London as the centre of finance; European countries will become quaint relics of a glorious past, rather like Athens and Rome today; global citizens will use Mandarin as much as, if not more than, English; the thoughts of Confucius will become as familiar as those of Plato; and so on.

All this makes for an interesting parlour game. Yet there is something too deterministic about Mr Jacques's economic and political extrapolations. The author does not allow for uncertainty, chaos and error. He predicts that history is about to restore China to its ancient position of global power. But might it not equally push China back into self-destructive upheavals such as the Great Leap Forward and the Cultural Revolution? After all, the same Communist Party remains in power and, as Mr Jacques puts it,

the Chinese state has never shared authority with anyone. He accords little importance to the thousands of protests in China, most of them against corruption and the loss of land. In his dense recitation of data, there is hardly a mention of the demographic crisis facing China, which means that the country could well become old before it becomes rich. He sees little risk of instability from ethnic unrest in Tibet or Xinjiang.

For Mr Jacques (the last editor of a defunct British magazine called *Marxism Today*), the Communist Party is a benign force, guiding the country through its spectacular boom while avoiding the collapse that afflicted the Soviet Union. He has little truck with the notion that free markets can only work, in the long term, in free societies; that liberty of thought leads more easily to innovation; that democratic states correct their mistakes more easily than authoritarian ones.

All this is a Western conceit, says Mr Jacques. Democracy and rule of law were not a precondition for the West’s economic power, but a coincidence. This argument is the most interesting (and contentious) part of Mr Jacques’s book, rather than his workaday account of Chinese history or the overlong prose about China being a “civilisation state” rather than a “nation state”.

The parting of ways between Europe and China came, in his view, not with the Renaissance or the Enlightenment but with the industrial revolution. Even so, the West’s success was not preordained. Until 1800, Mr Jacques argues, the most advanced parts of China and Europe had reached comparable levels of development. Indeed, China had built a form of steam engine before James Watt. So why did the industrial revolution begin in Britain and not along the Yangzi river? In large part, it was an accident of history.

Britain, like China then, suffered from a shortage of land. But Britain had coal, which replaced firewood as a fuel, and colonies with slaves providing plenty of farmland and cheap labour. The habit of war “helped to hone the European nation states into veritable fighting machines” and the incorporation of merchant classes into the elites encouraged European rulers to promote capitalism. By contrast, claims Mr Jacques, imperial China’s attachment to Confucian values of harmony meant its main concern was to keep order and social equality within its domains. So it was not the West’s superior values that allowed it to rule the world, but rather its flaws.

If colonisation assisted Western hegemony, the end of the colonial era after the second world war set the stage for the rise of China. Its economic development from 1978 has been “the most extraordinary in human history”, more rapid than that of Europe or America, faster even than that of Japan, South Korea and the other Asian miracles. Conflict of the sort that accompanied the rise of Germany and Japan cannot be ruled out, says Mr Jacques, but there is a good chance that it can be avoided. “China does not aspire to run the world because it believes itself to be the centre of the world,” he writes. Perhaps so. For now China is developing in collaboration with the West. It relies on Western investment and markets, and seeks stability abroad.

The West hopes that wealth, globalisation and political integration will turn China into a gentle giant, a panda rather than a dragon. George Bush senior declared in 1999: “Trade freely with China and time is on our side.” But Mr Jacques says this is a delusion. Time will not make China more Western; it will make the West, and the world, more Chinese.

**The Taliban and drugs**

# What to do?

Jul 9th 2009
From The Economist print edition

**Seeds of Terror: How Heroin is Bankrolling the Taliban and al-Qaeda**. By Gretchen Peters. *Thomas Dunne; 320 pages; $25.95. To be published in Britain by Oneworld Publications in September*. Buy from Amazon.com

**To Live or To Perish Forever: Two Tumultuous Years in Pakistan**. By Nicholas Schmidle. *Henry Holt; 254 pages; $25 and £18.99*. Buy from Amazon.com, Amazon.co.uk

IT IS rare that a journalist writes about some aspect of American foreign policy, makes an impassioned plea for change and finds her advice adopted.

Richard Holbrooke, the Obama administration's man for South Asia, announced last month that, in the revamped campaign against the Taliban, America would no longer push for the eradication of opium crops, which he said was counterproductive and a waste of money. Instead, America would target the traffickers who back the Taliban, and then lure the impoverished Afghan opium farmers to the American side with alternative crops.

Mr Holbrooke did not cite Gretchen Peters's new book, "Seeds of Terror", but his script sounded eerily similar to her careful analysis of the nexus between the Taliban, the poppy fields and the White House. Ripping up opium plants with tractors and threatening to kill crops by aerial spraying with lethal chemicals has pushed Afghan farmers into the grip of the militants, she argues. "I'm a spray man myself," Ms Peters quotes President George Bush as saying. But spraying helped the traffickers and their terrorist brethren by driving up opium prices, increasing margins and making life harder for the farmers, exactly the outcome that America did not want.

To persuade policymakers to acknowledge that the Taliban was largely financed by heroin took a surprisingly long time. American forces resisted taking on the drug traffickers who were well connected to the government in Kabul. That was not the job they were there to do, argued the Pentagon. By last year the connection between drugs and terrorism became hard to avoid. The Drug Enforcement Administration estimated that opium provided the Taliban with 70% of its revenue. About 50 refineries operated in Taliban-held areas. In short, says Ms Peters, the Taliban had turned into a new FARC, the Revolutionary Armed Forces of Colombia, the terrorist group that became so adept at supporting rural peasants against their corrupt government.

Nicholas Schmidle, also an American journalist, spent less time in Pakistan. But his intrepid journeys into the urban tumult of Karachi, the inner sanctums of extremist mosques and the tribal areas make up for his comparatively short stay. He dyed his blond hair brown, wore the Pakistani local garb of *shalwar kameez* and engaged Taliban fighters in conversation in Urdu, which he speaks well.

Mr Schmidle, whose father is a general in the American marines, befriended Abdul Rashid Ghazi, the Taliban leader who was killed by the army during the Red Mosque siege in Islamabad in 2007. Mr Schmidle is persuaded that, as long as it continues to be badly led by a corrupt government and inept military establishment Pakistan risks becoming another "jihadistan".

Wherever he went, the Taliban seemed to be getting help: from religious leaders, from parts of the army and from the powerful security service. The tendency among Washington policymakers is to lump Afghanistan and Pakistan together as Afpak, a designation Pakistanis find demeaning. Mr Schmidle makes clear that Pakistan, proud of its sovereignty, needs deep and reasoned attention from the West, not just bundles of development aid. By contrast, Ms Peters's portrait of Afghanistan shows just how much America dictates what goes on there.

**Henry Kissinger in 1973**

# A year to remember

Jul 9th 2009
From The Economist print edition

**Kissinger: 1973, The Crucial Year.** By Alistair Horne. *Simon & Schuster; 457 pages; $30. To be published in Britain as "Kissinger's Year" by Weidenfeld and Nicolson next month*. Buy from Amazon.com

Rex Features

**Let me handle this, Mr President**

THE year 1973 was Henry Kissinger's *annus mirabilis*. Early on he announced it would be the "Year of Europe". In the end that was almost the only thing it was not.

With dazzling virtuosity and scarcely credible stamina, President Richard Nixon's national security adviser and later secretary of state developed the previous year's opening to China. He negotiated an end, though not a happy one, to the Vietnam war, and began the process of detente with the Soviet Union, even at the price of a kiss on the lips from Leonid Brezhnev.

He took advantage of Anwar Sadat's expulsion of Soviet advisers from Egypt to replace the Soviet Union with America as the dominant power in the Middle East. He ordered planeloads of military equipment for Israel to help it survive the Yom Kippur war. With his boss often too "loaded" with alcohol to take part, Mr Kissinger on his own initiative called Brezhnev's bluff by raising American forces to Defcon3, the third highest state of war readiness. Finally he swung into the pyrotechnics of his "shuttle diplomacy" to bring Israel and its Arab enemies together at Geneva.

Deterred from attempting a full-length biography by the 30 tonnes of Mr Kissinger's archive, Sir Alistair Horne, a British historian of modern France, wisely chose to focus on this apex of Super-K's career. He tells the story racily and well, though with some slips. (The Duke of Wellington won at Waterloo by "hard pounding", not "hard slogging"; Ronald Reagan was scarcely unknown in 1973; and the State Department has not been 100 yards from the White House since 1947.)

Sir Alistair's authorised version, while not uncritical, is certainly partisan. Spectacular as Mr Kissinger's diplomatic triumphs were, it can be argued that many of their long-term consequences were not always benign. His handling of the Yom Kippur war has left America with what may prove to be an unsustainable commitment in the Middle East. It is not that Mr Kissinger, as a Jew, was too partial to Israel; on the contrary, as Sir Alistair shows, he leant over backwards to avoid that. But the author's worst failing is his total misunderstanding of Watergate. He interprets it as self-interested irresponsibility on the part of the *Washington Post*, exploited by Democratic politicians for partisan purposes. For him, their frivolity robbed the world of an era of peace, made possible by Mr Nixon's flawed strategic genius and Mr Kissinger's brilliant diplomacy.

When Americans speak of Watergate, they are referring not only to the break-in at the Watergate building, but the whole course of illegal behaviour that Mr Nixon encouraged to improve his chances of winning the 1972 election. This was paranoid folly; he would have won anyway. Far from being wrong, it was brave and public-spirited of the *Washington Post* to investigate conduct that threatened the integrity of American democracy. And the Democrat-led Congress was right to expose it.

Mr Nixon and Mr Kissinger did seize diplomatic opportunities with consummate skill. But Sir Alistair, in his admiration for these bravura performances, and for his hero's undeniable charm, glosses over how indifferent Mr Kissinger was to the internal dynamics of nations. He treated them like so many chess pieces, flattering and bullying their leaders, and often seeming to respect them only in so far as they could enhance American power. To believe that, but for the irresponsibility of the *Washington Post* and the Ervin Committee, he would have bequeathed the world a generation of world peace, is too much.

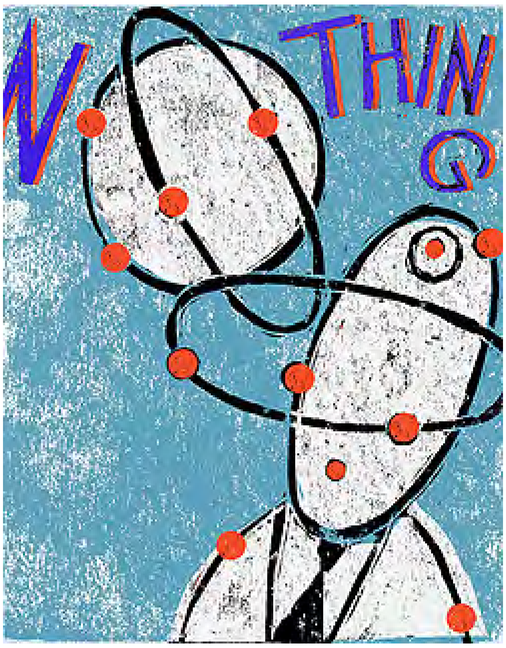
Physics and philosophy

# Much ado about nothing

Jul 9th 2009
From The Economist print edition

**Nothing: A Very Short Introduction**. By Frank Close. *Oxford University Press; 157 pages; £7.99. To be published by OUP in America next month*. Buy from Amazon.co.uk

Illustration by Daniel Pudles




DOES anything remain when everything is taken away? This question has perplexed philosophers for thousands of years. In a new treatment, Frank Close, a physicist, examines the latest scientific thinking on the subject.

Most scientists believe that the universe was born in the Big Bang some 14 billion years ago. The vastness of space, its smattering of galaxies and stars, its planets and the conscious life that inhabits at least one such orb all came from this giant fireball. Not only was matter created at that point, so too were the forces that govern it and the fields that they generate. Further, time itself burst forth. Where did all this stuff come from? Science says that it came from quantum fluctuations in the void.

That, in turn, raises questions about what the void might be. Stripped of all matter, forces and fields, would space and time exist? The universe is expanding, being thrust apart by some mysterious “dark energy”, minute traces of which pervade all space. Is dark energy the “cost” of having free space?

Mr Close argues that emptiness is a collective effect similar to that of magnetism, which occurs in isolation but only when many atoms are present. Physicists call such phenomena “emergent” because they depend on a multiplicity of relatively simple interactions. Mr Close reckons that consciousness may be a collective effect, too.

He outlines how the Higgs field, which is thought to be responsible for endowing matter with mass and thus enabling gravity to act on it, may also be a collective property. Physicists are engaged in the biggest scientific experiment in the history of the world at CERN, the European particle physics laboratory, in an attempt to find the particles associated with this field and thereby confirm its existence. The Higgs field is thought to have pervaded the void ever since a trillionth of a second after the Big Bang.

Move away from the collective scale, however, and peer closer at empty space, that is, a volume from which all matter and forces have been removed, and it buzzes with energy. The smaller the space, the greater the fluctuations in the energy that pervades it. This makes the void fizz with activity, as particles and their antimatter counterparts zip in and out of existence. It is this activity, at quantum mechanical scales, that banishes nothingness and which is thought to have given birth to the universe.

Mr Close surveys 3,000 years of thinking to arrive at the modern solution to the question of where everything came from. The answer is nothing. Why the universe is as it is remains an enigma to science.

**Science and the Enlightenment**

# Gift of illumination

Jul 9th 2009
From The Economist print edition

**The Age of Wonder: How the Romantic Generation Discovered the Beauty and Terror of Science**. By Richard Holmes. *Pantheon Books; 552 pages; $40. HarperPress; £25*. But from Amazon.com, Amazon.co.uk

RICHARD HOLMES'S new book, which was published to great acclaim in Britain last October and is now, finally, coming out in America, is a captivating study of the late 18th and early 19th centuries, the heyday of Romantic science. Romanticism is generally perceived as the polar opposite of science, "its ideal of subjectivity eternally opposed to that of scientific objectivity". But Romantic science emerges from this subtle, illuminating and hugely enjoyable work as an idea of many parts.

Known principally for his biographies of Samuel Taylor Coleridge and Percy Bysshe Shelley, Mr Holmes has found a new set of heroes in Sir Joseph Banks, a botanist, an astronomer, Sir William Herschel, and Sir Humphry Davy, a chemist. The Romantic scientists were coevals of the great poets of the time, Coleridge and William Wordsworth, Shelley and John Keats. Intellectually, they shared "a common ideal of intense, even reckless, personal commitment to discovery", driven by a sense of wonder at the mysteries of the universe. The voyage of discovery, whether geographical or experimental, was an almost genetic characteristic in the Romantic scientists, exemplified by Davy's experiments on himself with nitrous oxide.

Two epic voyages, Captain Cook's in the *Endeavour* from 1768 and Charles Darwin's in the *Beagle* from 1831, define Mr Holmes's period. But the author teases out a deeper and more elusive meaning in the links between the scientists and the great Romantic poets. Coleridge, who was fascinated by things scientific, in particular, made the connection between the work of poet and scientist explicit.

"The Age of Wonder" is the long-awaited fermentation of the author's knowledge of the Romantic poets and his lifelong fascination with science. The presiding spirit of the book is Banks who sailed to Tahiti with Cook and became president of the Royal Society at the age of 35 in 1778. Having established his reputation early, Banks spent the rest of his life promoting both British science and the careers of his protégés. He died in 1820, having been, in Alan Moorehead's phrase, the "virtual dictator of scientific affairs in England".

Herschel, an eccentric musician from Hanover who came to England and devoted himself to astronomy, discovering Uranus in 1781, was another Romantic whose methods were rigorously scientific. Herschel invented and built unprecedentedly powerful telescopes. Assisted by his indomitable sister, Caroline, he mapped the heavens more accurately and to a greater depth than anyone had managed before him. Davy, a Cornishman and another pioneer, invented the safety lamp that saved the lives of countless miners. Together with the supporting cast, from Mungo Park to Mary Shelley, they offer a powerful "sense of individual wonder, the power of hope, and the vivid but questing belief in the future of the globe."

## The Hermitage Amsterdam

# Carousel of treasures

Jul 9th 2009
From The Economist print edition

**The Hermitage's new satellite museum in Amsterdam should encourage visitors to spend an extra day in the Dutch capital**

Roos Aldershoff

**From Russia with love**

THE Dutch queen and the Russian president watched as fireworks soared above the River Amstel. The Hermitage Amsterdam, a new museum for exhibiting loans of Russian art, was officially open, with an inaugural show entitled "At the Russian Court: Palace and Protocol in the XIXth Century". The evening's celebrations were televised live. Local residents seemed uniformly pleased, proud and relieved. At last a museum success story.

Amsterdam is famous for its outstanding galleries. However, the Rijksmuseum has been under reconstruction since 2003 and the Stedelijk, with its internationally celebrated collection of modern art, since 2004. Their reopening, pushed back repeatedly, appears to be years away. But the Hermitage Amsterdam, the radically renovated Amstelhof (a nursing home from its construction in the 17th century until 2007) was on budget, at €40m ($56m), and speedy, taking just two years to complete. The running costs will be covered by ticket sales and corporate sponsors. (The St Petersburg Hermitage will receive €1 from each full-price entry.) Ernst Veen, a cultural entrepreneur, masterminded the scheme and is now the museum's director. Many feel that his spearheading of this public-private partnership, rare in the Netherlands, is the key to its success. Not one of the original sponsors has dropped out, despite the turmoil in the financial markets. Their confidence has been vindicated. Hans van Heeswijk's architectural renovation is a triumph.

The Amstelhof, a severely handsome, four-sided brick building enclosing a large garden, is huge. But its interior was so poorly altered in the 1970s that practically all that remained of the original was its classical façade and roof. Mr van Heeswijk's plan called for gutting the interior. The resulting exhibition spaces range from the intimate to the enormous. The two largest are double-height galleries 34 metres long and ten metres wide. Yet the visitor does not feel dwarfed. On the contrary; there is a rather dreamy, floaty feeling about this place, radiant with natural light.

Care has been taken to enhance this with transparent or translucent materials. The stairs are steel and tinted glass, the doors transparent glass. The interior's vast expanses of white walls, where the signs are white on white, add to the glow. Even inconsequential objects gain in lustre.

Alas, there are rather a lot of them in this inaugural exhibition. The 1,800 loans include none of the masterpieces for which the Hermitage is famous. Instead, this is a lesson on 19th-century Russian court life. Half the material is related to protocol. One rather static display consists of gowned and uniformed mannequins. But another, entitled "To the Ball", is a *coup de théâtre*. Dance music plays; the round display cases revolve. Through the silver painted outline of a window on a wall are film images of men and women twirling, a scene from "Russian Ark", which was shot in St Petersburg's Hermitage.

In the peripheral galleries there is a good deal to charm—displays of fans, dancing slippers, parasols and

jewellery. A vitrine devoted to hunting contains three delightful and unusual game bags. All pretty enough, but certainly not great treasures. For masterworks visitors have to wait until March 6th when "Origins of Modern Art: Braque, Matisse and Picasso" opens. That promises to be a show that will truly salute the magnificence of the Amstelhof.

Economist.com
PEOPLE
OBITUARY

# Robert McNamara

Jul 9th 2009
From The Economist print edition

**Robert McNamara, systems analyst and defence secretary, died on July 6th, aged 93**

LBJ Library and Museum

QUANTIFICATION was a word Robert McNamara loved. Numbers could express almost any human activity. Well, perhaps not beauty, honour, love. But certainly the rigours of a youthful trip to sea (19 bed-bug bites on one leg), and the pleasure of climbing Mount Whitney, all 14,495 feet. Five or six bullet points, reinforced when you saw him with vigorous hand-chops, summed up any argument. There were four McNamara steps to changing the thinking of any organisation, including the Pentagon: state an objective, work out how to get there, cost out everything, systematically monitor progress against the plan. There were 11 lessons to be learned from the war in Vietnam, but most of them occurred to him too late.

Things you could count, he said, you ought to count. At the Ford Motor Company, where he was one of the ten “Whiz Kids” brought in in 1946 to shake things up, all the components of each new Chevy (made by GM) would be laid out on a table to inspect. This was not cheating, but competitive evaluation. At the Air Force Office of Statistical Control, where he worked in 1943-45, he counted the firebombing sorties made by the B-29s, at what height, with what percentage hits on target (58% of Yokohama, 51% of Tokyo). System and data together helped win that war. In the Pentagon in 1965, again by applying metrics—targets hit, captives taken, weapons seized, the enemy’s body-count—he could tell with equal certainty that America was losing.

The South Vietnamese, America’s allies, were cavalier with numbers. Hence his frustration with them. The enemy Vietcong made each person count. After saturation American bombing in 1965, Mr McNamara found they were still getting 200 tons of supplies a day along the Ho Chi Minh trail, and had scattered the country with a secret stash of oil in hundreds of 55-gallon drums. The importance of tiny peasant efforts to the health of a nation struck him again when, from 1968-81, he headed the World Bank, shifting its focus and its money to rural development.

He saw himself as an “enlightened rationalist”, and looked the part, with his oiled hair and boffin’s glasses and strict attention to time. If business had not called, in the shape of Henry Ford, and if public service had not called later, with John Kennedy asking him to take first Treasury and then Defence, he might have stayed at Harvard teaching economics. Not long after joining Kennedy’s White House, he

drew the president a little graph of his authority: power on the vertical axis, his putative two terms on the horizontal, with effectiveness a declining line between them. Sadly, his horizontal axis proved too long.

It was often his fate to be saddled with bad numbers. At Ford it was the Edsel, a clunker-car with contrasting tail-fins and unlovely squarish styling, which sold only 68,045 in 1958, its first year, and 47,496 in its second, until he killed it in favour of the smaller, cheaper Falcon. At the Pentagon, where he arrived in 1961 with 99 topics for evaluation, he found a budget of $55 billion that had to be trimmed by bringing in systems analysis and five-year plans. He forced cuts in bases and procurement on the outraged joint chiefs, only to find some money mysteriously restored again.

But the worst numbers appeared from the mid-1960s, in a series of ever-increasing demands from General William Westmoreland in Vietnam: a force of 210,000 by the end of 1965, 325,000 by July 1966, 410,000 by that December. Vietcong numbers smoothly kept pace, despite losses estimated at 60,000 a year. Figures for Americans killed in action ran at 400-500 a month, ever upwards. Mr McNamara, ordered to win the war and clinging to his statistical strategy of attrition, approved the troop increases. But his company-man efficiency was often rattled. At cabinet meetings, especially with the "rough", Lyndon Johnson (far left), he would nervously hitch up his trousers, sigh, bury his head in his hands. It was all unravelling. When in 1968 "Westy" asked for 200,000 more men, he left. He had once been happy to take responsibility for "McNamara's war". But as he admitted later, in penitent memoirs and interviews, he had not understood the variables of war itself.

## The limits of reason

At the height of the conflict, he was called a baby-burner. His son marched against him. Jackie Kennedy once pummelled his chest with her fists, crying at him to "stop the slaughter". All this was difficult. He was an instinctive liberal, driving a battered Ford, living in university suburbs, where his recommended book for the reading group was Camus's "L'Etranger". Warmongering was not in his nature.

He was haunted by the thought that amid all the objective-setting and evaluating, the careful counting and the cost-benefit analysis, stood ordinary human beings. They behaved unpredictably. During the Cuban missile crisis of 1962, which he had lived through at cabinet level, "Kennedy was rational. Khrushchev was rational. Castro was rational." Yet between them they had pushed the world to the brink. Rationality, he concluded, "will not save us." Perhaps what would were the little quirks that had made him love John Kennedy: the president's sudden capacity to be empathetic, surprised, intuitive, and ready to jettison his most confident calculations.

## Overview

Jul 9th 2009
From The Economist print edition

The IMF released fresh growth forecasts on July 8th. It now expects **America**'s economy to shrink by 2.6% this year, an improvement of 0.2 percentage points over its previous estimate, released in April. However, it reckons that the recession in the **euro area** will be even deeper than it had earlier predicted: GDP in the countries that use the euro is now forecast to shrink by 4.8% this year, a downward revision of 0.6 percentage points. This, together with greater pessimism about Latin America and eastern Europe, has led it to revise its prediction for global GDP growth down by 0.1 percentage points, to -1.4%.

Industrial production in **Germany** increased by 3.7% in May, after falling by 2.6% the previous month. May's rise was the biggest monthly increase since 1993, raising hopes that the German economy, which shrank by 6.9% in the year to the first quarter, was on the mend.

**British** industrial production continued to decline. A fall of 1.8% in the three months to May left industrial output 11.9% lower than a year earlier.

**Brazil's** annual inflation rate declined to 4.8% in June from 5.2% a month earlier, opening up space for further interest-rate cuts in Latin America's largest economy, which experienced its second successive quarter of negative GDP growth in the first three months of this year.

Prices in **Chile** rose by 1.9% in the year to June, and were 0.3% higher than in May, when the annual rate of inflation was 3%.

# Output, prices and jobs

Jul 9th 2009
From The Economist print edition

## Output, prices and jobs

% change on year ago

| | Gross domestic product | | | | Industrial production | Consumer prices | | | Unemployment |
|---|---|---|---|---|---|---|---|---|---|
| | latest | qtr* | 2009† | 2010† | latest | latest | year ago | 2009† | rate‡, % |
| United States | −2.5 Q1 | −5.5 | −2.7 | +2.0 | −13.4 May | −1.3 May | +4.2 | −0.4 | 9.5 Jun |
| Japan | −8.8 Q1 | −14.2 | −6.1 | +1.0 | −29.5 May | −1.1 May | +1.3 | −1.1 | 5.2 May |
| China | +6.1 Q1 | na | +7.2 | +7.6 | +8.9 May | −1.4 May | +7.7 | −0.5 | 9.0 2008 |
| Britain | −4.9 Q1 | −9.3 | −3.7 | +1.1 | −11.9 May | +2.2 May§ | +3.3 | +1.7 | 7.2 Apr†† |
| Canada | −2.1 Q1 | −5.4 | −2.2 | +1.9 | −9.9 Apr | +0.1 May | +2.2 | +0.6 | 8.4 May |
| Euro area | −4.9 Q1 | −9.8 | −4.4 | +0.6 | −21.6 Apr | −0.1 Jun | +4.0 | +0.4 | 9.5 May |
| Austria | −3.5 Q1 | −10.6 | −3.2 | +0.2 | −10.9 Apr | +0.3 May | +3.7 | +0.5 | 4.3 May |
| Belgium | −3.0 Q1 | −6.2 | −3.5 | +0.4 | −19.9 Apr | −1.1 Jun | +5.8 | +0.4 | 11.0 May‡‡ |
| France | −3.2 Q1 | −4.8 | −2.9 | +0.7 | −18.8 Apr | −0.3 May | +3.3 | +0.2 | 9.3 May |
| Germany | −6.9 Q1 | −14.4 | −6.0 | +0.6 | −18.1 May | +0.1 Jun | +3.3 | +0.2 | 8.3 Jun |
| Greece | +0.3 Q1 | −4.6 | −3.0 | −0.9 | −11.7 Apr | +0.5 Jun | +4.9 | +0.4 | 9.2 Mar |
| Italy | −6.0 Q1 | −10.1 | −5.0 | +0.4 | −24.2 Apr | +0.5 Jun | +3.8 | +0.9 | 7.3 Q1 |
| Netherlands | −4.5 Q1 | −10.7 | −4.5 | +0.7 | −13.2 Apr | +1.4 Jun | +2.6 | +1.3 | 4.5 May†† |
| Spain | −3.0 Q1 | −7.4 | −3.8 | −0.6 | −22.3 May | −0.9 May | +4.6 | −0.3 | 18.7 May |
| Czech Republic | −3.4 Q1 | −12.9 | −3.0 | +1.2 | −21.7 May | +1.2 Jun | +6.7 | +1.7 | 8.0 Jun |
| Denmark | −4.1 Q1 | −4.2 | −3.7 | +0.6 | −16.5 May††† | +1.3 May | +3.4 | +1.2 | 3.5 May |
| Hungary | −6.7 Q1 | −9.6 | −6.0 | −1.0 | −22.1 May | +3.8 May | +7.0 | +3.3 | 9.8 May†† |
| Norway | +1.5 Q1 | −1.8 | −2.0 | +0.5 | −7.8 May | +3.0 May | +3.1 | +2.0 | 3.1 Apr*** |
| Poland | +0.8 Q1 | na | −0.8 | +1.5 | −5.2 May | +3.6 May | +4.4 | +2.5 | 10.8 May‡‡ |
| Russia | −9.5 Q1 | na | −5.0 | +2.0 | −17.1 May | +11.9 Jun | +15.2 | +12.1 | 9.9 May‡‡ |
| Sweden | −6.5 Q1 | −3.6 | −5.1 | +1.1 | −21.9 May | −0.6 Jun | +4.3 | −0.3 | 9.0 May‡‡ |
| Switzerland | −2.4 Q1 | −16.0 | −2.2 | +0.4 | −9.4 Q1 | −1.0 Jun | +2.9 | −0.5 | 3.8 Jun |
| Turkey | −13.8 Q1 | na | −4.5 | +1.2 | −17.4 May | +5.7 Jun | +10.6 | +6.2 | 16.1 Q1‡‡ |
| Australia | +0.4 Q1 | +1.5 | −0.2 | +1.7 | −0.7 Q4 | +2.5 Q1 | +4.2 | +1.8 | 5.8 Jun |
| Hong Kong | −7.8 Q1 | −16.1 | −6.0 | +1.1 | −10.2 Q1 | +0.1 May | +5.6 | +1.0 | 5.3 May†† |
| India | +5.8 Q1 | na | +5.5 | +6.4 | +1.4 Apr | +8.6 May | +7.8 | +5.2 | 6.8 2008 |
| Indonesia | +4.4 Q1 | na | +2.4 | +3.1 | +1.5 Apr | +3.7 Jun | +11.0 | +4.2 | 8.4 Aug |
| Malaysia | −6.2 Q1 | na | −3.0 | +1.2 | −11.5 Apr | +2.4 May | +3.8 | −0.4 | 3.0 Q4 |
| Pakistan | +5.8 2008** | na | +1.3 | +2.3 | −20.6 Mar | +13.1 Jun | +21.5 | +12.0 | 5.6 2007 |
| Singapore | −10.1 Q1 | −14.6 | −8.6 | +1.3 | +2.0 May | −0.3 May | +7.5 | −0.2 | 3.3 Q1 |
| South Korea | −4.2 Q1 | +0.5 | −5.0 | +0.6 | −9.0 May | +2.0 Jun | +5.5 | +1.6 | 3.9 May |
| Taiwan | −10.2 Q1 | na | −6.9 | +0.5 | −18.2 May | −2.0 Jun | +5.0 | −1.3 | 5.8 May |
| Thailand | −7.1 Q1 | −7.3 | −4.5 | +1.9 | −10.0 May | −4.0 Jun | +8.8 | −1.0 | 2.1 Apr |
| Argentina | +2.0 Q1 | +0.2 | −3.5 | +0.5 | −12.2 May | +5.5 May | +9.1 | +7.0 | 8.4 Q1‡‡ |
| Brazil | −1.8 Q1 | −3.3 | −1.5 | +2.7 | −11.3 May | +4.8 Jun | +6.1 | +4.7 | 8.8 May‡‡ |
| Chile | −2.1 Q1 | −2.4 | −1.0 | +2.2 | −10.5 May | +1.9 Jun | +9.5 | +2.1 | 10.2 May††‡‡ |
| Colombia | −0.6 Q1 | +0.9 | −1.2 | +2.5 | −14.5 Apr | +3.8 Jun | +7.2 | +5.0 | 12.1 Apr‡‡ |
| Mexico | −8.2 Q1 | −21.5 | −7.1 | +2.8 | −13.2 Apr | +6.0 May | +4.9 | +5.5 | 5.3 May‡‡ |
| Venezuela | +0.3 Q1 | na | −4.1 | −2.7 | −0.9 Jan | +27.4 Jun | +32.2 | +30.2 | 8.1 Q1‡‡ |
| Egypt | +4.3 Q1 | na | +4.0 | +3.8 | +5.7 Q4 | +10.2 May | +19.7 | +9.7 | 9.4 Q1‡‡ |
| Israel | +0.5 Q1 | −3.6 | −1.0 | +1.6 | −10.4 Apr | +2.8 May | +5.4 | +2.7 | 7.6 Q1 |
| Saudi Arabia | +4.2 2008 | na | −1.0 | +3.1 | na | +5.5 May | +10.4 | +4.3 | na |
| South Africa | −1.3 Q1 | −6.4 | −2.2 | +3.1 | +8.4 Apr | +8.0 May | +11.7 | +6.6 | 23.5 Mar‡‡ |
| **MORE COUNTRIES** Data for the countries below are not provided in printed editions of *The Economist* | | | | | | | | | |
| Estonia | −15.1 Q1 | na | −13.0 | −3.0 | −30.0 May | −0.9 Jun | +11.4 | nil | 13.9 Apr |
| Finland | −7.6 Q1 | −10.3 | −5.6 | −0.1 | −21.0 Apr | nil May | +4.2 | +0.3 | 8.6 May |
| Iceland | −3.9 Q1 | −13.6 | −12.1 | −0.7 | +10.1 2008 | +12.2 Jun | +12.7 | +12.5 | 8.7 May‡‡ |
| Ireland | −8.5 Q1 | −5.7 | −7.5 | −2.8 | +3.3 Apr | −4.7 May | +4.7 | −3.5 | 11.9 Jun |
| Latvia | −18.0 Q1 | na | −17.0 | −4.0 | −19.3 May | +3.4 Jun | +17.7 | +2.5 | 17.4 Apr |
| Lithuania | −13.6 Q1 | −35.8 | −15.0 | −4.5 | −19.3 May | +4.2 Jun | +12.5 | +5.5 | 8.7 Apr‡‡ |
| Luxembourg | −5.2 Q4 | −16.8 | −5.0 | −0.9 | −38.9 Mar | −0.3 May | +4.0 | +0.5 | 5.5 Apr‡‡ |
| New Zealand | −2.2 Q1 | −2.7 | −2.6 | +0.7 | −7.2 Q4 | +3.0 Q1 | +3.4 | +1.4 | 5.0 Q1 |
| Peru | −2.0 Apr | na | +1.3 | +2.6 | −13.6 Apr | +3.1 Jun | +5.7 | +3.8 | 8.5 May‡‡ |
| Philippines | +0.4 Q1 | −8.9 | −1.8 | +2.3 | −15.5 Apr | +1.5 Jun | +11.4 | +2.9 | 7.5 Q2‡‡ |
| Portugal | −3.7 Q1 | −6.2 | −4.1 | −0.3 | −7.9 May | −1.2 May | +2.8 | −0.7 | 8.9 Q1‡‡ |
| Slovakia | −5.6 Q1 | na | −5.0 | +0.7 | −23.9 May | +2.2 May | +4.6 | +1.6 | 11.4 May‡‡ |
| Slovenia | −8.5 Q1 | na | −5.0 | +0.5 | −24.9 Apr | +0.3 Jun | +7.0 | +1.1 | 8.8 Apr‡‡ |
| Ukraine | −8.0 Q4 | na | −12.0 | +1.0 | −31.8 May | +15.0 Jun | +29.3 | +16.0 | 2.6 May |
| Vietnam | +4.5 Q2 | na | +2.1 | +4.9 | +5.4 Apr | +3.9 May | +25.2 | +6.0 | 4.6 2007 |

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions. §RPI inflation rate -1.1 in May. **Year ending June. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

# *The Economist* commodity-price index

Jul 9th 2009
From The Economist print edition

## *The Economist* commodity-price index

2000=100

| | Jun 30th | Jul 7th* | % change on one month | % change on one year |
|---|---|---|---|---|
| **Dollar index** | | | | |
| All items | 183.0 | 178.3 | −6.6 | −32.9 |
| Food | 203.4 | 195.7 | −9.7 | −27.6 |
| **Industrials** | | | | |
| All | 156.5 | 155.8 | −1.2 | −39.9 |
| Nfa† | 121.8 | 123.0 | −5.8 | −39.6 |
| Metals | 175.5 | 173.7 | +0.7 | −40.1 |
| **Sterling index** | | | | |
| All items | 168.5 | 167.0 | −6.1 | −18.2 |
| **Euro index** | | | | |
| All items | 120.6 | 117.8 | −6.6 | −24.8 |
| **Gold** | | | | |
| $ per oz | 938.05 | 925.00 | −2.7 | +1.1 |
| **West Texas Intermediate** | | | | |
| $ per barrel | 69.97 | 62.53 | −10.6 | −54.0 |

*Provisional †Non-food agriculturals.

# *The Economist* poll of forecasters, July averages

Jul 9th 2009
From The Economist print edition

***The Economist* poll of forecasters, July averages** (previous month's, if changed)

| | Real GDP, % change: Low/high range | | Real GDP, % change: average | | Consumer prices % increase | | Current account % of GDP | |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 |
| Australia | −1.6/0.4 | 0.7/2.7 | −0.2 (−0.8) | 1.7 (1.6) | 1.8 | 2.4 (2.3) | −4.1 (−4.7) | −4.6 (−5.4) |
| Belgium | −4.5/−2.8 | −0.8/1.3 | −3.5 (−3.3) | 0.4 (0.2) | 0.4 (0.5) | 1.2 (1.3) | −2.4 (−1.8) | −2.5 (−1.7) |
| Britain | −4.1/−2.9 | −0.5/1.9 | −3.7 | 1.1 (0.6) | 1.7 (1.5) | 1.9 (1.7) | −1.7 (−1.6) | −1.4 (−1.2) |
| Canada | −2.9/−1.2 | 0.7/2.5 | −2.2 (−2.3) | 1.9 (1.7) | 0.6 (0.3) | 1.8 (1.7) | −1.8 (−1.9) | −1.0 (−1.1) |
| France | −3.5/−2.6 | −0.4/1.8 | −2.9 (−2.8) | 0.7 (0.5) | 0.2 | 1.0 | −2.2 | −2.5 |
| Germany | −6.6/−5.3 | −0.9/2.0 | −6.0 (−5.5) | 0.6 (0.5) | 0.2 | 0.8 | 3.9 (4.4) | 3.9 (4.2) |
| Italy | −5.6/−4.6 | −0.5/1.4 | −5.0 (−4.4) | 0.4 (0.3) | 0.9 (0.7) | 1.4 | −2.8 (−2.6) | −2.9 (−2.6) |
| Japan | −7.4/−2.1 | 0.1/2.3 | −6.1 (−6.7) | 1.0 (0.8) | −1.1 | −0.6 (−0.5) | 1.9 (1.7) | 2.4 (2.0) |
| Netherlands | −4.9/−4.0 | −0.3/1.6 | −4.5 (−3.9) | 0.7 (0.5) | 1.3 (0.9) | 0.9 | 6.1 (5.9) | 5.4 (4.6) |
| Spain | −4.5/−3.2 | −1.5/0.5 | −3.8 (−3.5) | −0.6 (−0.5) | −0.3 (−0.1) | 1.3 (1.4) | −7.2 (−7.5) | −6.2 (−6.6) |
| Sweden | −5.6/−4.5 | 0.2/2.4 | −5.1 (−4.6) | 1.1 (0.9) | −0.3 (−0.4) | 1.2 (1.0) | 7.0 (7.3) | 6.8 (7.1) |
| Switzerland | −3.6/−1.5 | −0.7/1.2 | −2.2 (−2.3) | 0.4 (0.3) | −0.5 | 0.4 | 7.6 | 8.0 (7.8) |
| United States | −3.3/−1.9 | 0.7/2.9 | −2.7 (−2.8) | 2.0 (1.6) | −0.4 (−0.8) | 1.3 (1.2) | −3.0 (−3.2) | −3.2 (−3.4) |
| Euro area | −4.7/−4.1 | −0.7/1.7 | −4.4 (−4.1) | 0.6 (0.5) | 0.4 | 1.1 (1.0) | −1.0 | −0.8 |

Sources: BNP Paribas, Citigroup, Decision Economics, Deutsche Bank, Economist Intelligence Unit, Goldman Sachs, HSBC Securities, KBC Bank, JPMorgan Chase, Morgan Stanley, RBS, Scotiabank, UBS

# Trade, exchange rates, budget balances and interest rates

Jul 9th 2009
From The Economist print edition

## Trade, exchange rates, budget balances and interest rates

| | Trade balance* latest 12 months, $bn | Current-account balance latest 12 months, $bn | Current-account balance % of GDP 2009† | Currency units, per $ Jul 8th | Currency units, per $ year ago | Budget balance % of GDP 2009† | Interest rates, % 3-month latest | Interest rates, % 10-year gov't bonds, latest |
|---|---|---|---|---|---|---|---|---|
| United States | −711.0 Apr | −628.3 Q1 | −3.0 | – | – | −13.7 | 0.32 | 3.29 |
| Japan | +5.1 May | +107.7 May | +1.9 | 94.1 | 107 | −6.8 | 0.42 | 1.29 |
| China | +293.9 May | +426.1 Q4 | +7.2 | 6.83 | 6.86 | −4.3 | 1.34 | 3.44 |
| Britain | −150.6 Apr | −52.5 Q1 | −1.7 | 0.62 | 0.51 | −13.9 | 1.15 | 3.61 |
| Canada | +28.0 Apr | −3.9 Q1 | −1.8 | 1.16 | 1.01 | −2.1 | 0.25 | 3.36 |
| Euro area | −54.7 Apr | −146.2 Apr | −1.0 | 0.72 | 0.64 | −5.9 | 1.03 | 3.28 |
| Austria | −5.4 Apr | +15.0 Q4 | +2.0 | 0.72 | 0.64 | −4.6 | 1.03 | 4.04 |
| Belgium | +5.0 Mar | −12.0 Mar | −2.4 | 0.72 | 0.64 | −5.8 | 1.04 | 3.89 |
| France | −73.9 May | −63.5 Apr | −2.2 | 0.72 | 0.64 | −6.6 | 1.03 | 3.65 |
| Germany | +196.3 May | +178.3 Apr | +3.9 | 0.72 | 0.64 | −4.6 | 1.03 | 3.28 |
| Greece | −58.8 Mar | −45.2 Apr | −8.8 | 0.72 | 0.64 | −6.5 | 1.03 | 5.00 |
| Italy | −13.7 Apr | −69.6 Apr | −2.8 | 0.72 | 0.64 | −5.2 | 1.03 | 4.43 |
| Netherlands | +44.8 Apr | +50.0 Q1 | +6.1 | 0.72 | 0.64 | −4.1 | 1.03 | 3.74 |
| Spain | −109.3 Apr | −124.7 Apr | −7.2 | 0.72 | 0.64 | −9.6 | 1.03 | 3.99 |
| Czech Republic | +4.1 May | −6.3 Apr | −1.9 | 18.8 | 14.9 | −4.7 | 2.08 | 5.73 |
| Denmark | +6.5 May | +8.5 May | +1.5 | 5.36 | 4.74 | −2.5 | 2.10 | 3.70 |
| Hungary | +1.3 May | −11.3 Q1 | −2.9 | 199 | 147 | −3.9 | 9.63 | 10.01 |
| Norway | +65.1 May | +79.6 Q1 | +12.5 | 6.54 | 5.11 | 7.2 | 1.82 | 4.11 |
| Poland | −18.2 Apr | −19.3 Apr | −5.7 | 3.18 | 2.08 | −4.0 | 4.33 | 6.22 |
| Russia | +132.5 May | +55.3 Q2 | +0.9 | 31.8 | 23.4 | −8.0 | 11.50 | 10.92 |
| Sweden | +12.8 May | +31.4 Q1 | +7.0 | 7.95 | 6.01 | −4.7 | 0.11 | 3.28 |
| Switzerland | +17.9 May | +56.6 Q1 | +7.6 | 1.09 | 1.03 | −3.1 | 0.39 | 2.20 |
| Turkey | −51.0 May | −26.7 Apr | −0.7 | 1.55 | 1.22 | −5.6 | 10.07 | 6.60‡ |
| Australia | +6.6 May | −29.8 Q1 | −4.1 | 1.27 | 1.04 | −4.2 | 3.12 | 5.31 |
| Hong Kong | −21.7 May | +29.3 Q1 | +10.4 | 7.75 | 7.80 | −4.0 | 0.30 | 2.37 |
| India | −96.4 May | −29.8 Q1 | −1.9 | 48.9 | 43.1 | −7.8 | 3.10 | 7.57 |
| Indonesia | +10.4 May | −0.8 Q1 | +0.9 | 10,200 | 9,173 | −3.0 | 8.50 | 7.50‡ |
| Malaysia | +41.7 Apr | +40.5 Q1 | +12.3 | 3.56 | 3.24 | −7.8 | 2.13 | 2.53‡ |
| Pakistan | −17.0 May | −12.2 Q1 | −2.1 | 81.7 | 71.5 | −5.0 | 12.01 | 14.71‡ |
| Singapore | +17.0 May | +23.1 Q1 | +14.9 | 1.46 | 1.36 | −4.1 | 0.50 | 2.25 |
| South Korea | +15.2 Jun | +17.2 May | +2.9 | 1,276 | 1,005 | −5.7 | 2.41 | 5.00 |
| Taiwan | +12.8 Jun | +29.2 Q1 | +9.6 | 33.0 | 30.4 | −5.2 | 0.85 | 1.44 |
| Thailand | +10.6 May | +8.3 May | +5.3 | 34.1 | 33.6 | −5.6 | 1.40 | 3.12 |
| Argentina | +15.8 May | +6.8 Q1 | +2.0 | 3.81 | 3.01 | −1.2 | 14.63 | na |
| Brazil | +27.5 Jun | −20.7 May | −1.3 | 1.99 | 1.61 | −2.0 | 9.16 | 6.16‡ |
| Chile | +4.5 Jun | −4.3 Q1 | −0.9 | 544 | 501 | −4.1 | 1.32 | 2.66‡ |
| Colombia | nil Apr | −6.5 Q1 | −3.7 | 2,104 | 1,723 | −3.4 | 5.32 | 6.04‡ |
| Mexico | −15.5 May | −14.2 Q1 | −2.7 | 13.4 | 10.3 | −5.4 | 4.65 | 7.79 |
| Venezuela | +32.5 Q1 | +26.2 Q1 | +1.1 | 6.50 | 3.35§ | −4.7 | 14.54 | 6.55‡ |
| Egypt | −26.1 Q1 | −2.9 Q1 | −1.5 | 5.58 | 5.35 | −7.1 | 10.16 | 3.18‡ |
| Israel | −10.2 May | +4.1 Q1 | +1.7 | 3.96 | 3.22 | −6.2 | 0.35 | 3.69 |
| Saudi Arabia | +197.4 2008 | +124.0 2008 | −2.1 | 3.75 | 3.75 | −5.1 | 0.65 | na |
| South Africa | −5.8 May | −18.7 Q1 | −5.8 | 8.17 | 7.68 | −4.1 | 7.58 | 9.23 |
| **MORE COUNTRIES** Data for the countries below are not provided in printed editions of *The Economist* | | | | | | | | |
| Estonia | −2.7 Apr | −1.0 Apr | −3.3 | 11.3 | 9.95 | −3.7 | 6.28 | na |
| Finland | +6.7 Apr | +3.4 Apr | +0.8 | 0.72 | 0.64 | −2.6 | 1.01 | 3.73 |
| Iceland | +0.3 Jun | −6.1 Q1 | +3.6 | 130 | 75.7 | −12.0 | 8.00 | na |
| Ireland | +47.6 Apr | −11.3 Q1 | −2.2 | 0.72 | 0.64 | −12.6 | 1.03 | 5.37 |
| Latvia | −4.6 Apr | −2.3 Apr | −2.0 | 0.50 | 0.45 | −8.0 | 14.45 | na |
| Lithuania | −4.8 Apr | −3.0 Apr | −2.0 | 2.48 | 2.19 | −6.1 | 8.44 | na |
| Luxembourg | −7.5 Mar | +2.2 Q1 | na | 0.72 | 0.64 | −3.7 | 1.03 | na |
| New Zealand | −2.2 May | −11.8 Q1 | −7.1 | 1.59 | 1.32 | −6.7 | 3.75 | 5.64 |
| Peru | +1.9 May | −3.8 Q1 | −2.9 | 3.03 | 2.81 | −2.3 | 3.00 | na |
| Philippines | −6.9 Apr | +5.1 Mar | +2.7 | 48.3 | 45.5 | −2.9 | 3.88 | na |
| Portugal | −31.6 Mar | −25.8 Apr | −9.9 | 0.72 | 0.64 | −6.0 | 1.03 | 4.33 |
| Slovakia | −0.1 Apr | −5.7 Apr | −7.0 | 21.7 | 19.3 | −5.5 | 1.35 | 4.28 |
| Slovenia | −3.8 Apr | −2.4 Mar | −1.7 | 0.72 | 0.64 | −5.1 | 1.03 | na |
| Ukraine | −13.4 Q1 | −10.1 Q1 | −0.3 | 7.66 | 4.58 | −4.3 | 11.02 | na |
| Vietnam | −5.0 Jun | −7.0 2007 | −10.2 | 17,803 | 16,850 | −8.8 | 7.98 | 7.07 |

*Merchandise trade only. †The Economist poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.

# Markets

Jul 9th 2009
From The Economist print edition

## Markets

| | | % change on | Dec 31st 2008 | |
|---|---|---|---|---|
| | Index Jul 8th | one week | in local currency | in $ terms |
| United States (DJIA) | 8,178.4 | −3.8 | −6.8 | −6.8 |
| United States (S&P 500) | 879.6 | −4.7 | −2.6 | −2.6 |
| United States (NAScomp) | 1,747.2 | −5.3 | +10.8 | +10.8 |
| Japan (Nikkei 225) | 9,420.8 | −5.2 | +6.3 | +2.4 |
| Japan (Topix) | 888.5 | −4.3 | +3.4 | −0.4 |
| China (SSEA) | 3,234.1 | +2.4 | +69.2 | +68.9 |
| China (SSEB, $ terms) | 196.6 | +1.4 | +77.5 | +77.2 |
| Britain (FTSE 100) | 4,140.2 | −4.6 | −6.6 | +4.5 |
| Canada (S&P TSX) | 9,653.5 | −7.0 | +7.4 | +14.2 |
| Euro area (FTSE Euro 100) | 710.1 | −6.2 | −4.8 | −4.9 |
| Euro area (DJ STOXX 50) | 2,291.3 | −6.5 | −6.4 | −6.4 |
| Austria (ATX) | 1,985.6 | −7.2 | +13.4 | +13.4 |
| Belgium (Bel 20) | 1,960.6 | −5.5 | +2.7 | +2.7 |
| France (CAC 40) | 3,009.7 | −6.4 | −6.5 | −6.5 |
| Germany (DAX)* | 4,572.7 | −6.8 | −4.9 | −5.0 |
| Greece (Athex Comp) | 2,163.2 | −3.3 | +21.1 | +21.1 |
| Italy (S&P/MIB) | 17,947.4 | −7.7 | −7.8 | −7.8 |
| Netherlands (AEX) | 244.6 | −6.0 | −0.5 | −0.5 |
| Spain (Madrid SE) | 973.5 | −5.4 | −0.3 | −0.3 |
| Czech Republic (PX) | 882.4 | −1.8 | +2.8 | +5.8 |
| Denmark (OMXCB) | 264.7 | −3.9 | +17.0 | +16.9 |
| Hungary (BUX) | 14,475.7 | −6.2 | +18.2 | +13.5 |
| Norway (OSEAX) | 313.5 | −7.3 | +16.0 | +24.2 |
| Poland (WIG) | 29,744.2 | −3.1 | +9.2 | +1.8 |
| Russia (RTS, $ terms) | 889.8 | −9.0 | +46.8 | +40.8 |
| Sweden (OMXS30)† | 777.5 | −4.5 | +17.4 | +16.8 |
| Switzerland (SMI) | 5,289.4 | −3.4 | −4.4 | −6.7 |
| Turkey (ISE) | 37,156.0 | −0.2 | +38.3 | +37.5 |
| Australia (All Ord.) | 3,766.0 | −2.7 | +2.9 | +13.6 |
| Hong Kong (Hang Seng) | 17,721.1 | −3.6 | +23.2 | +23.2 |
| India (BSE) | 13,769.2 | −6.0 | +42.7 | +42.2 |
| Indonesia (JSX) | 2,083.2 | +1.1 | +53.7 | +64.2 |
| Malaysia (KLSE) | 1,065.5 | −1.3 | +21.5 | +18.0 |
| Pakistan (KSE) | 7,476.1 | +4.2 | +27.5 | +23.5 |
| Singapore (STI) | 2,259.8 | −3.9 | +28.3 | +26.5 |
| South Korea (KOSPI) | 1,431.0 | +1.4 | +27.3 | +25.6 |
| Taiwan (TWI) | 6,668.1 | +1.4 | +45.2 | +44.3 |
| Thailand (SET) | 575.9 | −3.6 | +28.0 | +30.6 |
| Argentina (MERV) | 1,477.8 | −8.2 | +36.9 | +24.1 |
| Brazil (BVSP) | 49,177.0 | −4.6 | +31.0 | +53.4 |
| Chile (IGPA) | 14,660.7 | −1.1 | +29.5 | +51.7 |
| Colombia (IGBC) | 9,811.5 | −2.1 | +29.8 | +38.7 |
| Mexico (IPC) | 23,469.0 | −4.3 | +4.9 | +8.3 |
| Venezuela (IBC) | 44,731.5 | +0.5 | +27.5 | +37.2 |
| Egypt (Case 30) | 5,524.3 | −3.1 | +20.2 | +18.6 |
| Israel (TA-100) | 785.2 | −3.3 | +39.2 | +32.8 |
| Saudi Arabia (Tadawul) | 5,413.2 | −3.3 | +12.7 | +12.8 |
| South Africa (JSE AS) | 22,014.1 | −3.1 | +2.3 | +15.8 |
| Europe (FTSEurofirst 300) | 817.1 | −5.6 | −1.8 | −1.8 |
| World, dev'd (MSCI) | 921.1 | −5.3 | +0.1 | +0.1 |
| Emerging markets (MSCI) | 739.5 | −4.3 | +30.4 | +30.4 |
| World, all (MSCI) | 234.5 | −5.2 | +3.0 | +3.0 |
| World bonds (Citigroup) | 804.6 | +0.6 | −0.7 | −0.7 |
| EMBI+ (JPMorgan) | 439.6 | −0.7 | +12.3 | +12.3 |
| Hedge funds (HFRX)§ | 1,077.6 | nil | +5.6 | +5.6 |
| Volatility, US (VIX) | 31.3 | 26.2 | 40.0 | (levels) |
| CDSs, Eur (iTRAXX)‡ | 139.5 | +11.2 | −31.0 | −31.0 |
| CDSs, N Am (CDX)‡ | 199.4 | +7.1 | −14.6 | −14.6 |
| Carbon trading (EU ETS) € | 13.4 | +0.8 | −17.2 | −17.2 |

*Total return index. †New series. ‡Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac. §Jul 7th

# Insurance

Jul 9th 2009
From The Economist print edition

The world's big insurance markets collected $4.3 trillion in premiums in 2008, according to Swiss Re, a global reinsurance firm. After adjusting for inflation, total premiums in life and non-life insurance markets fell by 2% last year, the largest decline since 1980. Although emerging-market premiums grew by more than 11%, they still only made up 12% of the total. Life insurance, which has been hardest hit by the financial crisis, still provides about 60% of total premiums. It has also grown more than twice as fast as non-life insurance in emerging markets, although Russia, where the market shrank 28%, is a notable exception. Britons bought the most insurance per person in 2008.